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Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—*From the Certificate of Incorporation.*

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TABLE OF CONTENTS PAGE

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What The U. S. Tax Court Means to Every Taxpayer and Tax Practitioner

By HON. BOLON B. TURNER

This is an address which was given at the monthly meeting of the Society at the Waldorf-Astoria Hotel on November 19, 1945.

ONE of the first things which we, as children, learned in our study of American history was that the imposition of certain taxes was a contributing cause of the American Revolution. The colonists fiercely resented the burden of any taxes where they had no voice in their imposition, and when freedom was finally won the founding fathers saw to it that control over the imposition of taxes should, as nearly as possible, remain in the hands of the people, and to that end, wrote into the Constitution the provision that revenue measures must originate in the House of Representatives. It is interesting to note, however, that practically no restrictions were placed upon the collecting officer in his determination of the amount of the tax and the collection thereof. Locally, the householder lists his property for ad valorem tax purposes, and in many jurisdictions, except for the functioning of something in the nature of a Board of Equalization, he does not to this day have any alternative but to pay the tax charged against him. The same was true with respect to excises. It may be that this was true because the taxes were simple and direct, the amount being largely a matter of mathematical computation, and there were therefore no serious complications such as we know today in the case of the income tax. On the other hand, I like to think and really do believe that it was because our statesmen and political leaders and the people generally accepted the proposition that if the Government was to function the collection of taxes once imposed must not be impeded or hampered by complicated procedure.

HON. BOLON B. TURNER is the Presiding Judge of the Tax Court of the United States, Washington, D. C. He graduated from the University of Arkansas and received the degrees of A.B., L.L.B. and L.L.M. from George Washington University. Prior to his present post, Judge Turner served as attorney in the office of the Secretary of the Treasury and also has served as attorney for the U. S. Board of Tax Appeals, the predecessor to the Tax Court of the United States.

It is true that from the beginning we have had some difficulties with taxpay-

ers or some who should have been taxpayers, but usually those difficulties have not been based on differences between the taxpayer and his Government with respect to the computation or determination of amount, but from opposition to the payment of any tax, or of a particular tax. To illustrate: Note the Whiskey Rebellion in Western Pennsylvania, immediately following the American Revolution; the smuggling or attempt to smuggle articles past our Custom Officers; the difficulties between the people of the hills and mountains sections and the "revenooers", as they termed the Internal Revenue Officers; and finally, the ever-present chiseler, who operates by omitting from his local assessment list as many items as he thinks may pass unnoticed. Once, however, the declaration was made, the determination of amount was wholly in the hands of the taxing authority and when the amount was determined, collection of the tax was permitted and effected by summary methods. It is true that in some instances the tax collector could be sued in person, but it was usually rather difficult to show that his actions were capricious or arbitrary to the extent necessary for recovery against him personally and about the only chance the taxpayer normally had to recover any amount or any part paid as taxes was to move with sufficient speed to catch the money still in the hands of the collector and before it had been paid into the treasury.

When the Sixteenth Amendment was adopted and the first of the Federal income tax statutes thereunder was enacted, the situation with respect to the collection of Federal taxes was generally this: The Commissioner, either on the basis of returns filed or upon such audits as were made, entered the amounts of tax upon assessment lists and certified them to the various collectors for collection. If the taxes so assessed were not paid on notice and demand they were usually collected under the warrants for distraint, or by some other summary method. There was nothing the taxpayer could do but pay. It was provided, however, that if the tax was paid under protest a claim for refund could be filed and upon rejection, or after the lapse of a specified period of time, suit for the recovery of the tax might be filed in the Court of Claims or in some instances in the Federal district court. In the district courts suit was often-times against the collector in person since in those cases an award of interest could sometimes be had, the suits being bottomed on an alleged wrongful act of an individual, and not directly against the United States. They were for all practical purposes, however, suits against the United States since the statute provided that if the court certified that the act of collection by the collector was reasonable the amount of the judgment should be payable out of the treasury, and I may say that I have never heard of an instance wherein the court did not so certify.

For a great number of years the machinery so set up appeared to be adequate, and, so far as I have been able to determine, there was no serious agitation or really great need for revision until the time of or after the close of the first World War, when Congress had placed on the statute books the first of our very complicated and far reaching income tax statutes. As in recent years the war had necessitated the imposition and collection of greatly increased revenue and war production had to a substantial extent provided a source and means for obtaining that revenue. As a result, we not only found ourselves with a normal tax at a fixed rate on the income of individuals but a surtax at graduated rates, and in addition to the flat rate tax imposed on the income of corporations a very complicated war profits and excess profits tax at graduated rates had also been imposed, and from that time forward a third party, namely, the Commissioner of Internal Revenue, has, for all practical purposes, been an interested party

in all business transactions of every individual and corporation. At that time, however, even the concepts of what constituted income had not been too well settled, to say nothing of the meaning and applicability of the many new and complex provisions of the statute. To carry the heavy burden thus thrust upon it, the staff of the Commissioner was wholly inadequate both in number and experience and it soon developed that due to the competition of private business the Bureau of Internal Revenue was unable to hold within its ranks the more apt of the employees which it did have. The result was that even though Congress had allotted a period of five years within which returns might be audited and the taxes due thereunder might be determined and assessed the Bureau was unable to complete the job within the time allowed, and it was a normal thing to find a great number of the employees of the Income Tax Unit during the period of some three to six months prior to March 15 of any year spending most of their time in getting out requests to taxpayers whose returns had not been audited and in respect to which the period of limitation was about to run, asking those taxpayers to sign waivers agreeing to an extended period for the determination of the correct amount of the tax, and in making summary audits of the returns of those taxpayers who did not agree to file such waivers to the end that an adequate amount of tax might be assessed against and collected from such taxpayers, leaving the ultimate determination of the correct amount to later action, such action being usually taken either under claims in abatement or claims for refund.

While that war did not so nearly approach the state of total war as the one which is now being concluded, business and industry did have a substantial and difficult job of reconversion, and to further complicate the situation a business depression occurred in 1920. Being inexperienced in the matter of making proper provision for the contingency of further liability in respect of the income and war profits taxes which had been imposed upon them business men and firms were not generally forewarned of the possibilities that they might be confronted before, during or after reconversion to peacetime pursuits, with claims by the Government that their income, war profits and excess profits taxes for the war years had been substantially understated and underpaid. During the years 1921, 1922, 1923 and 1924, those things were in many instances suddenly brought to their attention in the form of notice and demand to pay very substantial additional amounts of tax, and in many instances they either did not have the money with which to pay or it was so tied up in the business that payment might be well nigh disastrous. Business and Government leaders were all in agreement that something should be done. The result was the Board of Tax Appeals created by the Revenue Act of 1924. The recommendation by the Committee on Ways and Means of the House of Representatives that a board to be known as the Board of Tax Appeals be created was stated in part as follows:

> The committee recommends the establishment of a Board of Tax Appeals to which a taxpayer may appeal prior to the payment of an additional assessment of income, excess-profits, war-profits, or estate taxes. * * * The right of appeal after payment of the tax is an incomplete remedy and does little to remove the hardship occasioned by an incorrect assessment. The payment of a large additional tax on income received several years previous and which may have, since its receipt, been either wiped out by subsequent losses, invested in nonliquid assets, or spent, sometimes forces taxpayers into bankruptcy, and often causes great financial hardship and sacrifice. These results are are not remedied by permitting the taxpayer to sue for the recovery of

the tax after this payment. He is entitled to an appeal and to a determination of his liability for the tax prior to its payment.

* * *

Under the provisions of the proposed bill creating a Board of Tax Appeals the taxpayer may, prior to the payment of the additional assessment of income, war-profits, excess-profits, or estate taxes, appeal to the Board of Tax Appeals and secure an impartial and disinterested determination of the issues involved. In the consideration of the appeal both the Government and the taxpayer will appear before the Board to present their cases, with the result that each member of the Board will sit soley as judge and not as both judge and advocate. * * * The divisions of the Board will sit locally throughout the United States to enable taxpayers to argue their cases with as little inconvenience and expense as is practicable.

In creating the Board, Congress limited its jurisdiction to additional amounts of tax, or deficiencies in tax, as such amounts were termed, determined by the Commissioner of Internal Revenue upon audits of the returns. If a taxpayer filed an appeal from the Commissioner's determination with the Board within the time prescribed by statute, assessment and collection of the tax by the Commissioner was barred until the Board's determination was made, except in cases where the Commissioner was of the belief that the assessment and collection of the deficiency might be jeopardized by delay, in which case he could proceed immediately with the collection. With its jurisdiction so defined, and armed with the provision that its proceedings should be conducted in accordance with such rules of evidence and procedure as the Board itself might prescribe, the Board of Tax Appeals set about doing the work for which it had been created.

Its first job was to determine the form in which the so-called appeals should be filed and the procedure to be followed. Since both the Government and the taxpayer were to appear and present their cases, and the members of the Board were to sit solely as judges, it was concluded that pleadings should be filed which would set and limit the issue for consideration to the precise questions in respect of which there was a difference or dispute between the parties. Otherwise much time might well be consumed with matters on which there was no dispute, and it might soon appear that the Board would not be able to handle the volume of business which would come before it. It is thus to be seen that the Board of Tax Appeals, in its inception and in its early functioning, was a grand experiment.

That the need for such an experiment was very real to the taxpayer, however, is indicated by the fact that in slightly more than two years time more than 8,000 cases had been filed, involving deficiencies in tax aggregating $134,000,000. The Board had in that period—at first with a membership of 12, and later of 16—disposed of some 3,600 of these cases, and its opinions, which filled four volumes of in excess of 1,200 pages each, had done much to settle many troublesome questions which had arisen as to the meaning and applicability of numerous provisions of the revenue statutes. It was in this situation that the Board of Tax Appeals, now the Tax Court, was constituted in its present form.

In proposing the new legislation, the Committee on Ways and Means in its report to the House of Representatives, said: "The provisions of the Revenue Act of 1924 creating the Board of Tax Appeals are continued in force with numerous amendments. The Board constitutes an imparital tribunal of experts, independent of the Treasury Department, readily available for the determination of tax liabilities as between the Government and the taxpayer. The

work of the Board has been uniformly praised by taxpayers, tax attorneys, and the Treasury Department. Representatives of the American Bar Association informed the committee that the Board functions speedily and definitely, is untrammeled by questions of administrative expedience, and renders decisions that are uniformly independent." Although by language of the statute enacted—The Revenue Act of 1926—the Board of Tax Appeals was continued "as an independent agency in the Executive Branch of the Government," it was in reality fitted into the judiciary, along side of the various Federal District Courts. It was provided that a taxpayer desiring a judicial determination of his tax liability must, upon the receipt of a notice of deficiency, make his election to proceed either through the Board of Tax Appeals prior to payment, or through the Court of Claims or the Federal District Courts, under the old method of first paying the tax, filing his claim for refund, and then suing to recover. He could not thereafter, as he had been able to do in the two years preceding, have the liability litigated first in the Board of Tax Appeals, and then, if the result did not suit, in the courts. It was provided, however, that upon petition by either the taxpayer or the Government the decision of the Board might be reviewed by the Circuit Court of Appeals for the circuit in which the taxpayer had filed his return, or, upon agreement, by Court of Appeals for the District of Columbia. The review in the Court of Appeals was to be wholly upon the record made before the Board and in making that record, it was provided that the rules of evidence prevailing in the Courts of Equity in the District of Columbia should be applied. The proceedings and determinations of the Board as judicial proceedings and determinations were thereby established by statute, as well as in fact.

The Board continued to function as so constituted until 1942, when its name was changed to The Tax Court of the United States, the title of each member was changed to that of Judge, and that of Charirnan to the Presiding Judge. Otherwise its form and method of transacting business continued as before.

From the creation of the Board of Tax Appeals in 1924, down to and including October 31, 1945, 122,317 income, profits, estate and gift tax cases have been docketed, an average of 5,825 per year, and during the same period, 117,317 of these cases have been closed, leaving on October 31, 1945, an even 5,000 of such cases pending before us. Digging further into the statistics, it occurred to me that it might be of interest to you to know, by way of comparison, the gross deficiencies determined by the Commissioner and the amount in dollars and cents allowed under the decisions of the Board and the Tax Court. I found, however, that our statistics had not been worked out in that respect on cases closed prior to July 1, 1927. From July 1, 1927, to October 31, 1945, we closed 110,660 cases, in which the gross deficiencies determined by the Commisssioner had been $3,841,981,676.06, and as redetermined pursuant to our findings of facts and opinions the said deficiencies had been reduced to $1,022,373,808.59. It thus appears that in dollars and cents the taxpayer has been the winner by a ratio of more than three to one. It might be well to state, however, that to some extent there were duplications in the amounts claimed by the Commissioner. To illustrate: The same tax is often set up against numerous transferees, and even if the full amount is allowed upon decision of the Tax Court, the duplications are eliminated. There are also other comparable situations.

You may also be interested in knowing the character of dispositions of the various cases. Of the 110,660 cases mentioned, 25,540 were disposed of by written findings of fact and opinions, and this means that hearings were had in that number of docketed cases, and findings and opinions were reduced

to writing. 71,773 were disposed of pursuant to stipulation or agreement of the parties. 10,327 were dismissed for one reason or another; 545 cases are classified as miscellaneous; and 2,475 were closed pursuant to mandates of the various Circuit Courts of Appeals. The fact that 25,540 of the cases mentioned were disposed of by written findings and opinions does not mean, however, that many separate opinions were written. Consolidations are often effected for trial and the writing of findings of fact and opinions. The actual number of written findings of fact and opinions amounted to 14,350. Of those, 3,832 were taken to the appellate courts, on which we were affirmed in 2,586 and reversed in 818. 194 were modified in some respect, while 122 were disposed of by compromise between the parties. It thus appears that more than thirteen out of each fourteen cases decided by the Board and the Tax Court stand as decided. It may be stated here that examination of the Federal Reporter indicates that the tax cases decided by the District Courts and the Court of Claims are comparatively few in number, and it may be reasonably said that the interpretation of the Federal tax statutes made by the Tax Court is in most instances accepted as settling its meaning and applicability, and there is no way of estimating with any degree of accuracy the thousands of cases closed pursuant to such interpretation in the Bureau and without appearance on our docket.

Before leaving the realm of statistics, I have another group of figures which may be of some interest to you. You may recall the statement read to you earlier from the 1924 report of the Committee on Ways and Means, to the effect that "The divisions of the Board will sit locally throughout the United States to enable taxpayers to argue their cases with as little expense and inconvenience as is practicable." For more than 15 years now, the hearings in Washington have, with few exceptions, been limited to the cases originating in Maryland, Virginia and the District of Columbia. Other cases are, for the convenience of the parties, locally set and heard. To give you some indication of the amount of travel required to be done by the 16 Judges, you might be interested in knowing that of the 122,317 cases filed from 1924 to October 31, 1945, only 3,706 originated in Maryland, Virginia and the District of Columbia. Here in New York, the Tax Court has its own court room, in the Grand Central Terminal Building, and from September through June of each year, some one of the Judges is conducting hearings approximately every other week.

At this point it might be well to tell you just what happens to a case between the time of trial and the promulgation by the Court of its findings of fact and opinion. The case is heard and decided by the Division to which it is assigned, and each member of the Court is a Division, the authority and duty of assignment of cases being placed by statute in the Presiding Judge. Because the statute requires written findings of fact, argument is made by briefs, and oral argument is seldom desired. 60 to 90 days are usually allowed for the filing of briefs. Upon the filing of briefs, the Division which heard the case, after a study of the evidence of record and consideration of the arguments advanced by the parties, prepares his findings and decides the case. The findings and opinions of the Division, under the provisions of the statute, become the findings and opinion of the Court, unless within 30 days the Presiding Judge directs that the report of the Division be reviewed by the Court. As a consequence, the findings and opinion of each and every Division, in each case heard and decided, is reviewed by the Presiding Judge. This review serves two purposes: One is to make certain, in so far as it is possible, that the reports in all cases which deserve and merit the consideration of the entire Court are referred to the Court for

review, while the other is to see that the other Members are not required to take time from their own cases to study and consider the reports in cases which do not merit further consideration and review. If this were not done and the Members of the Court had to consider every case decided, we could not begin to hear and decide the great number of cases which come before us. By this procedure, conflicts in the decided cases are reduced to a minimum. Cases dealing with new principles receive the consideration of the Court as a whole, and not merely that of the Member deciding the case and of the Presiding Judge. While at the same time, purely fact cases, as well as cases which are clearly within the scope of cases already decided, are disposed of without the delay of review. Where the opinions are such that it is thought they may be of some value as precedents, they are printed in our published reports. Where they present nothing new, or because of the peculiar state of the facts, or the character of the question involved, they are considered to be decisive of the instant case only, they are not published, but are released in memorandum form. In the 21 years of its existence, the Board, now the Tax Court, has promulgated some 52 volumes of findings and opinions.

Discussion of the subject of the functioning of the Tax Court should not be concluded without taking note of the part played by the attorneys and technical men representing the Commissioner of Internal Revenue. During the first few years of the existence of the Board of Tax Appeals, it was a very easy matter for the representatives of the Bureau to resolve all doubts for the Government, and leave the taxpayer to his remedy before the Board. It was equally apparent that many taxpayers did not make great efforts to settle their cases with the Bureau officials, but stood firm on many contentions that might have been settled by negotiations, and, upon receipt of the Commissioner's notice of deficiency, filed his petition with the Board. The result was that in spite of the efforts of the Members of the Board, the number of undecided cases pending in May of 1928 had reached the figure of 23,061. To help this situation, the Commissioner organized a staff or technical men and gave them the authority and power to conclude the settlement of cases which were of such character that they should not occupy the time and attention of the Board. In or about 1939, both the Technical Staff and the attorneys under the Chief Counsel for the Bureau of Internal Revenue were placed in offices in various of the leading cities of the United States, where they could be in close contact with the taxpayers and their representatives, and it has been through the combined efforts of those men, the taxpayers and their counsel and the continued work of the members of the Tax Court that our docket has now been brought within the bounds of reason.

We still have a difficult task ahead. Excess profits tax cases are now coming in in substantial numbers. We also have on our docket some 300 of the so-called renegotiation cases involving the determination of excessive profits under war contracts. In this latter group of cases and certain of the excess profits tax cases, our responsibility is, if that is possible, greater than in other cases, since in the cases mentioned our decision is final and there is no review by an appellate court. Trial of the first of the renegotiation cases will take place here in New York, beginning December 10. We are hopeful that we may be able to carry our load and keep reasonably in step in our disposition of cases with the cases docketed. As to whether or not we will be successful will depend not only on our efforts, but on the cooperation and assistance given by the taxpayers and their representatives, as well as the technical men and attorneys for the Government.

We well realize that we have complicated statutes to deal with, to interpret and to apply, and that it is difficult,

oftentimes, to find the answer. We are, however, living in difficult and complicated times, and it seems to me that I might at this point pass on to you a thought which has at numerous times been in my mind. Here it is. When the taxpayer and you who are his representatives, his lawyers, and the Tax Court and other tribunals begin to read the current provisions of the Internal Revenue Code and feel that they are so complicated, that they have become impossible of understanding, we might well think back and realize that some from our number have in fact been responsible to a very great extent for the complex state of those statutes. In some instances, undoubtedly, we of the Tax Court have not reasoned out our conclusions as well as we might have. Sometimes we have possibly drawn distinctions which are altogether too refined. And in the case of taxpayers and their representatives, much of what we have has resulted from the efforts of the too clever lawyer or the too clever accountant in trying to figure out some way to avoid or beat the tax in a particular instance, and when he has succeeded, Congress has found it necessary to plug another hole and further expand the patchwork-quilt type of statute we have. We all have our responsibility, and it behooves each and every one of us to do as earnest and sincere job as we know how; to see that each and every taxpayer pays every penny of tax that he rightly owes, and that he pays no amount as taxes which is not due from him.

Income Tax Problems in Realty Transactions

By CHARLES MEYER, C.P.A.

Mr. Meyer delivered three addresses on the same subject, during October and November, 1945, before the New York State Society of Certified Public Accountants, the Union County (New Jersey) Bar Association and New York University Institute on Federal Taxation. His talk to members of the Society was delivered on October 11, 1945, at a meeting conducted by the Society's Committee on Federal Taxation at the Engineering Auditorium, 29 West 39th Street, New York City.

INTRODUCTION

NOW that the war is over the real estate and building industries anticipate a boom era. Many of us have experienced the situation where after considerable negotiation between a prospective buyer and seller of property, the deal fell through. The seller was most likely advised by his lawyer or accountant that the resultant transaction would have serious tax consequences and the expected net profit on the sale would be greatly reduced or the seller was advised that because of "conflicting" court decisions no definite conclusion could be made. Where such transactions are discontinued it obviously hurts business and eventually must affect the level of employment.

CHARLES MEYER, C.P.A. and lawyer has been a member of the Society since 1928. He is now serving as a member of the Society's Committee on Federal Taxation. He received a B.C.S. degree from New York University in 1923 and an L.L.B. degree from that university's law school in 1929 and was admitted to the New York Bar in 1933. Mr. Meyer is also a member of the New York County Lawyers Association and the American Bar Association and is a member of the Committee on Federal Excess Profits Taxes of the latter bar association. He has written several articles on taxation and has made many addresses on the subject. He was a guest lecturer at Rhode Island State College and New York University Institute on Federal Taxation. He now lectures on taxes at Rutgers University and the New York Institute of Finance, formerly known as New York Stock Exchange Institute. Mr. Meyer is engaged in the general practice of law in his own office in New York City.

The various refinements and distinctions of the law of property and contract precludes a fair and workable conclusion for tax purposes. This statement was made by the United States Supreme Court in the case of Helvering vs. Hallock[1]. In many other cases, too numerous to even cite, the Courts have disregarded accounting concepts in the determination of tax problems. Thus income tax law has reached its maturity, as such, and has become unique as a special branch of law. Furthermore, many matters involve mixed questions of both law and fact and the Supreme Court in the now famous Dobson case[2] has indicated that the lower Tax Court should have exclusively within its province only questions of fact and that questions of law only may be reviewed by higher courts on appeal. It is for the foregoing reasons that each particular problem must be analyzed in detail and with extreme care. In addition—now more than ever —accountants and lawyers must co-

[1] Helvering *vs.* Hallock, 309 U. S. 106.
[2] Dobson *vs.* Comm., 302 U. S. 489.

operate with each other, so that the tax-paying public will receive the greatest benefit of their combined abilities.

The chief difficulty, in a limited discussion of such an important and comprehensive topic as realty income tax problems, is not what to include herein but what not to omit. Accordingly, only the more troublesome items will be presented for discussion.

Lessor and Lessee

If a cash basis lessor receives rent from the lessee it is taxable income for the year in which received even though the rent is paid for a later year—Morris-Poston Coal Co.[3] As to a taxpayer on the accrual basis the rent should be reported as income in that taxable year when events have occurred which fix both the amount of the income and determine that the amount will be received—Leo M. Klein.[4] In case of litigation the necessary events will be considered to have occurred in the year the litigation is terminated—Jamaica Water Supply Co.[5] There have been numerous cases, and the principal is now definitely established that advance rentals; bonuses or royalties received by the lessor upon the execution of a lease or for making a new lease must be fully included as taxable income in the year of receipt and cannot be pro-rated over the demised term and it is immaterial whether or not the taxpayer is on the cash or accrual method of accounting.[6] The doctrine is based on the theory that the receipts are held by the lessor under a claim of right and without restriction as to their disposition. The lessor may use the funds as he wishes. As to the lessee who pays rent in advance such a taxpayer must apportion the payment over the life of the lease and it is immaterial that such lessee is on the cash basis—Baton Coal Co.[7]

In connection with rental deposits and tenants security that might have to be repaid under the provisions of a lease it is necessary to properly interpret the clauses in the lease. The latest case on this subject was decided in 1942 re the Clinton Hotel Realty Corp.[8] In that case the taxpayer received $21,000 on the execution of the lease as a deposit for security of the tenth and last year of the term and as further security for other provisions in the lease. The Court held that if it was considered paid as "rent in advance" it was taxable though not yet earned but it went further and pointed out that the other terms and provisions of the lease considered the payment as "security" or a "deposit" and in the event that the property was destroyed and the owner of the building failed to rebuild the payment was not to apply against the last year's rent. It therefore held in favor of the taxpayer holding no gain was realized on the sum so received.

Very often leases provide that the lessee in addition to the usual rental payments shall also make other payments such as taxes which has been held to constitute taxable income to the lessor Boston & Maine R.R. Co.[9] However, if the lessee is required to pay special assessments levied against the property such payments on lessor's behalf is not taxable income and is analogous to an improvement by the

[3] Morris—Poston Coal Co. *vs.* Comm., 42 F (2) 620.

[4] Leo M. Klein Co., 20 BTA 1057.

[5] Jamaica Water Supply Co., 42 BTA 359.

[6] Michigan Central R.R. Co, 79 F (2) 247 Cert. denied 296 U. S. 653; Comm. *vs.* Lyon, 97 F (2) 70; Crile *vs.* Comm., 55 F (2) 804; Chateau Frontenac *vs.* Comm., 147 F (2) 856; Hirsch Improvement Co. *vs.* Comm., 143 F (2) 912 Cert. denied.

[7] Baton Coal Co. *vs.* Comm., 51 F (2) 469 Cert. denied 284 U. S. 674.

[8] Clinton Hotel Realty Corp. *vs.* Comm., 128 F (2) 968; cf. Warren Service Corp. *vs.* Comm., 110 F (2) 723; See also Center Investment Co., 43 BTA 46; See also Astor Holding Co. *vs.* Comm., 135 F (2) 47.

[9] U. S. *vs.* Boston & Maine R.R. Co., 279 U. S. 732; See also Old Colony Trust Co. *vs.* Comm., 279 U. S. 716.

lessee and in the nature of a capital expenditure Estate of Markham.[10]

Where lessee pays a consideration to the lessor for the cancellation of a lease the lessee is permitted a full deduction in the year of payment Cassatt case[11] and the lessor must report the receipt as wholly taxable as set forth in the Jennings and Hort cases.[12] It is interesting to note, that in connection with advance rentals and advance bonuses, there was no reciprocity in tax result as between lessor and lessee whereas here the lessor has ordinary income and the lessee has an ordinary current deduction.

Should the lessor have to pay the lessee for such a cancellation then of course the lessee has ordinary income but the lessor must pro rate such payment over the remaining term of the lease as set forth in the Miller and Borland cases.[13] If the lessor immediately thereafter leased the same premises to a new lessee at, let us say, twice the old rental and received in advance the entire amount due under the new lease then the logical argument would be that only the net difference from both transactions should be reported as income in the taxable period. This could be based on the theory that the lessor purchased and sold a leasehold interest—and even if it is considered the sale of a capital asset the net result would be a short term capital gain but still to greater advantage, taxwise, then being forced to pro rate the cost of cancelling the old lease and reporting the new advance rental in its entirety. Incidentally the regulations[14] imply that a leasehold for 30 years or more is considered real estate and pursuant to Section 117 of the Internal Revenue Code real estate used in a trade or business is not a capital asset.

Where the purpose of the lessor in cancelling the old lease was to erect a new building on the demised premises then the cancellation cost must be capitalized and added to the cost of the new building Business Real Estate Trust.[15]

Contract of Sale Forfeitures and Options

If a vendee is liable under the usual contract to take title to a parcel of realty but for some reason he cannot or does not wish to do so an interesting situation develops. His lawyer will advise him that he is subject to a law suit and liable for damages for the breach of the contract and in addition forfeit his deposit to the vendor. If the deposit is forfeited he may deduct the full amount as an ordinary loss for since there is no sale or exchange involved thereby the capital gain and loss provisions of the code do not apply. However, if the vendee gets a release on his contractual liability from the vendor he automatically changes the transaction to one resulting in a capital loss on the theory of an "exchange", John C. Evans.[16] Here is a good illustration where the accountant and lawyer must cooperate. The accountant may consider other taxable transactions affecting the taxpayer during that year and he may be able to report to the lawyer that the client has other capital gains to offset any possible capital losses. The lawyer will now be in a position of weighing all the legal advantages and disadvantages of getting his client said release. The accountant here is in no position to advise the client since it must be stressed again that even if the

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[10] Estate of Wm. F. Markham, BTA Memo. Op. Dkt. 108332.

[11] Cassatt *vs.* Comm., 137 F (2) 745; See also Denholm & McKay Co., 2 BTA 444.

[12] Hort *vs.* Comm., 313 U. S. 28 (1941); Jennings & Co., Inc. *vs.* Comm., 59 F (2) 32 (1932).

[13] Harriet Borland, 27 BTA 538; Henry B. Miller, 10 BTA 383.

[14] Regulations 111, Sec. 29.112 (b) (1)-1.

[15] Business Real Estate Trust of Boston, 25 BTA 191 (Non-Acq).

[16] John C. Evans *vs.* Comm., 118 F (2) 901; Cf. Ganopuls 39 BTA 1120 (Non-Acq); Cf. Estate Walter Haass, BTA Memo. Op. Dkt. No. 103588.

deposit is forfeited the vendee may still be subject to a law-suit.

Insofar as the vendor is concerned the forfeited deposit is considered ordinary income as long as there has been no sale or exchange.[17]

An "option" to purchase real estate is an asset separate and distinct from the property subject to the option and the legal relationship between the "optionor" and "optionee" is quite different from the "vendor"—"vendee" relationship discussed in the preceding paragraphs. The optionee, generally, may without any further liability forfeit his option payment or payments. If the optionee fails to exercise his option a short term capital loss results to him and a short term capital gain results to the optionor. A forfeiture causes this result regardless of the holding period and regardless of whether the property subject to the option is a non-capital asset. Now this is not a question of following a court decision but the result of Congressional enactment as set forth in section 117(G)(2) of the Internal Revenue Code. However, it should be noted that it is only the *failure to exercise* the option that brings the latter section into play. If a *sale of the option* takes place it may be a long term transaction or a non-capital asset transaction based upon the facts in each case. This principal is clearly recognized in a ruling.[18]

In the leading case on the subject of options—Virginia Coal & Coke Co.[19] it was further held that the optionor must account for the option payments only in the year when the option is terminated by exercise or forfeiture. The most recent case—Mary P. Hunter[20]—decided in 1944 by the Circuit Court—Fifth Circuit, the question was one involving an "option" on securities but the principles are the same. In the latter case the taxpayer gave the optionee the right to make payments over a period of years until the whole purchase price was paid. She received payments in 1937, 1938 and 1939 and being on the cash basis reported income for these years. It was during 1939, however, that the optionee notified the taxpayer that no more payments would be made and that the option money therefore became forfeited. The Commissioner in the audit of taxpayer's 1939 return, included, as a short term capital gain for 1939, the entire payments for the three years. The Tax Court sustained the Commissioner's position and the Circuit Court affirmed by invoking and applying the Supreme Court rule of the Dobson Case supra.[21] The Circuit Court held that it had not a question of law to consider but a question of "fact" of proper accounting which under the Dobson rule the lower Tax Court had already decided and the Circuit Court was bound thereby. It is interesting to note that the decision in this Hunter case infers that "proper accounting" to the Tax Court may not necessarily be the "accounting" generally acceptable to the accounting profession.

In relation to leases containing option rights of lessee to buy property two Bureau rulings should be considered.[21] In the Haverstick case[22] the payments were held to be rental income in the absence of an allocation in the legal instruments as between rents and payments on account of the purchase price. In the case of Alexander W. Smith[23] the payments under the lease were held to create the relationship of vendor-vendee under a conditional sale rather than one of lessor-lessee. Additional factors to consider are whether the pay-

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[17] U. S. *vs.* National City Bank, 21 Fed. Supp. 791.

[18] G.C.M., 23,677 1943 C.B. 370.

[19] Virginia Iron, Coal & Coke Co. *vs.* Comm., 99 F (2) 919—CCA 4 (1938); Cert. denied 307 U. S. 630.

[20] Mary P. Hunter *vs.* Comm., 140 F (2) 954 CCA 5 (1944).

[21] I.T. 1819 II—2 C.B. 73; A. R.M. 189 I—2 C.B. 68.

[22] Haverstick *vs.* Comm., 13 BTA 837.

[23] Alexander W. Smith Jr., Executor *vs.* Comm., 20 BTA 27.

ments created any equity in the realty and did they give rise to the legal right of "specific performance."

Capital Gains and Losses

For our discussion let us consider that all real estate assets are capital assets whether or not connected with a trade or business unless (a) the realty is held primarily for sale to customers in the ordinary course of taxpayer's trade or business (b) the realty is used in a trade or business and (c) the property is depreciable property used in a trade or business.

Any type of taxpayer engaged in the real estate business may not inventory said real estate as set forth in the Atlantic Coast Realty Co. case.[24]

The best approach to these problems is to determine First: is the property a capital asset; Second: was there a "sale or exchange"; Third: what was the holding period; Fourth: does Section 117(j) of the Internal Revenue Code apply. Property may be classified in various categories and for our application the following is tabulated:

I. Used as a residence.

II. Residential property converted to income producing purposes.

III. Isolated real estate investments.

IV. Realty held as part of an investment program for income yield (as distinguished from III) and considered a "trade or business."

V. Factory or other building used as part of a non-real estate business.

VI. Realty held primarily for sale to customers in the ordinary course of the enterprise — "dealers".

VII. Property received by inheritance.

VIII. Property received as a gift.

A corporation gets its authority from its charter and since all activities of a corporation "constitute its trade or business" it can be generally stated that all real estate held by a corporation is used in its trade or business and therefore considered non-capital assets. See note[25] re letter of Deputy Commissioner.

Insofar as individual property owners are concerned we can state that the property in classifications I, II and III are considered capital assets. As to classification IV there have been conflicts in the reported cases and the question has been determined chiefly on intent and evidential matters. See the case of Fackler[26] and special ruling of Bureau relating to this classification. In the latter case a lawyer who visited his property a few times a month was held to be engaged in a trade or business and the gain on the sale of a 99 year lease (considered as real estate) was treated as ordinary gain even though the lawyer proved he devoted most of his time to his profession. Of course now such a taxpayer would get the benefits of Section 117(j). Property under classification V or VI is specifically exempt by the law and treated as non-capital in nature. In connection with real property inherited or acquired by gift the purpose for which the property is used will determine whether it is a capital or non-capital asset.

Residential property if sold at a profit causes "capital gain" to arise for the owner but no loss on a sale is allowed.[27] Even if there is a gain no depreciation is considered in connection with such sale. If the residence is converted to

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[24] Atlantic Coast Realty Co., 11 BTA 416.

[25] Prentice-Hall Federal Tax Service, 1943 Vol. 4 Par. 66, 121; Commerce Clearing House, 1945 Vol. 2 Par. 875.013 etc.

[26] Fackler *vs.* Comm., 133 F (2) 509; See also Commerce Clearing House, 1945 Vol. 3 Par. 6100.

[27] Gevirtz *vs.* Comm., 123 F (2) 707; Regulations 111 Sec. 29.23 (e) 1; Cf. Campbell 5 T.C. 30.

business use (say rented to others) and is so used and then sold at a loss that portion of the loss which occurred subsequent to the conversion is deductible and the basis for computing loss is the cost or the value of the residential property on the conversion date—whichever is lower. Here depreciation on the building must be considered in the computation, whether sold at a gain or loss.

Where an individual owns one or two rental producing properties and depreciation deductions are or have been permitted as deductions—it does not automatically follow that such properties are non-capital assets.[28-29] The real test is to determine how much time the owner devotes to collection of rents and general management of the property and whether his principal source of income is derived therefrom. During the war many individuals were restricted in their regular business activities and changed their methods of operation. Now that the war is over they may or may not resume their pre-war activities and this might affect their status as being now engaged in a real estate trade or business.

Let us now consider the hypothetical case of the man who in the early part of 1941 purchased extensive unimproved acreage with the intention of sub-dividing into small lots for a residential development and sale. He no doubt was a "dealer" then. During the war because of building and other restrictions he could not carry out his original plans and he became a real estate broker and still is a real estate broker. He is now offered a huge profit on the unimproved property and he does not know whether or not to sell, especially when he considers the possibility of the Treasury Department claiming him to be a "dealer" and the entire profit taxable as ordinary gain. The case of Three States Lumber Company[30] might be of some help in this situation. In the latter case it was held that "property held primarily for sale to customers is not limited to property purchased primarily for resale, but includes property purchased for an entirely different purpose." It therefore appears that the controlling factor is the purpose for which the property continued to be held. While the case is not exactly the situation in our hypothetical case, nevertheless, the principal should be controlling and if our hypothetical taxpayer can show that he now holds said acreage for an entirely different purpose than originally intended he might be able to establish a "non-dealer" status and get the benefits of Section 117(j) which does not apply to "dealers."

A special ruling[31] states that when a bank, mortgage company or building and loan association offers realty for sale originally acquired on foreclosure it is considered holding such property primarily for sale and is not a capital asset. This ruling, to date, has not been definitely upheld in any reported decision and consequently it appears that such taxpayers may not be able to get any of the benefits of Section 117(j) if such property is given "dealer" status.

In connection with holding period of property it should not be overlooked that a beneficiary of a decedent's estate is generally considered to have held the property from the date of decedent's death regardless of the fact that the actual delivery to such beneficiary is made months or even years after death.[32] If the beneficiary receives the property from a trustee then the holding period commences from the date of the trustees purchase of said property.[33] If the executor, for inheritance tax

[28] Heiner *vs.* Tindle, 276 U. S. 582.

[29] Regulations 111 Sec. 29.117—1; Cf. Estate of Annie Gibney Deceased Memo. Op. No. 6184—9/10/45.

[30] Three States Lumber Company, T.C. Memo. Op. 5588.

[31] G.C.M. 21497, C.B. 1939—2, p. 187.

[32] G.C.M. 19884, 1938—1 C.B. 290.

[33] Helvering *vs.* Reynolds, 313 U. S. 428.

purposes, elected to value the decedent's property one year after death or on its distribution date if the property is distributed within one year after death the holding period for the beneficiary commences from such date of valuation.[34]

In connection with gifts after December 31, 1924 the donor's base is used even if the donor required the property before that date.[35] If the property is sold at a loss then the market value of the property at the time of the gift is the basis if it is lower than donor's basis. The holding period in each instance commences from the date used for determing the basis on the transaction. The date of passing of title is not as decisive as to when a gift was completed as the fact that the donor relinquished substantial dominion and control over the property. If a sale of property is made at cost which is below the market value — the difference is usually treated as a gift.[36]

Section 117 (j) and Illustration A

Many practitioners have failed to completely understand the practical application of this section of the Code. Three classes of property are grouped together as if they were all in the same category, viz: (a) sales or exchanges of "property used in a trade or business" and held over six months (b) involuntary conversions of such "property used in a trade or business" and held over six months and (c) involuntary conversions of all types of capital assets held over six months. For the purposes of this section "property used in a trade or business" includes property subject to a depreciation allowance and real property used in a trade or business but does not include property includible in "inventory" and property held primarily for sale to customers in the ordinary course of business such as "dealers" in real estate. Furthermore the term "involuntary conversion" includes losses from destruction, theft, fire, condemnation, etc., of other capital assets even though not used in a trade or business — (included in item (c) above). Therefore, if residential property, a capital asset, held over six months, is totally destroyed by fire and no insurance recovery is had, the loss is grouped in item (c) above.[37]

The term "recognized gains" or "recognized losses" has also confused many practitioners. The confusion has to a great extent been due to the misinterpretation of Section 117(b) which is partially quoted below:

> ". . . only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss and net income: . . ."

The aforesaid quotation, either literally or legally, in no ways indicates that after the percentages are applied do you have a resultant "recognized" amount. To the contrary, it shows that the gain or loss "recognized upon the sale" is the amount before applying any percentages. Also see Sections 111(c) and 112(a) of Code.

Illustration A

FACTS

Taxpayer A purchased a vacant lot in 1930 for $7,000 and immediately erected a factory building thereon at a cost of $30,000. In August, 1945 the land and the building was sold for $43,000. At the time of sale the adjusted basis of the building—after deducting depreciation—was $20,000. In March, 1945 A sold a machine (in use over 6 months at his factory) for $2,000

[34] Sections 113 (a) 5 and 811 (j) of Internal Revenue Code—relates to decedents dying after October 21, 1942.

[35] Taft *vs.* Bowers, 278 U. S. 470; Wilson Bros. & Co. *vs.* Comm., 124 F (2) 606; Section 113 (a) 2 Internal Revenue Code.

[36] I. T. 3335, C.B. 1939—2.

[37] See illustration Reg. 111, Sec. 29.117-7 including loss on pleasure yacht.

—the adjusted basis of the machine, at the time of sale, being $3,000. In 1935 A erected a residence on a vacant lot he owned—said residence cost $15,000 and in July, 1945 a fire totally destroyed same and unfortunately through some oversight his fire insurance policy lapsed for non-payment of premiums in May, 1945. At the time of the fire A's house was reasonably valued at $10,000. For the purposes of Section 117(j) the following computation is made:

Land and Factory Building		
Adjusted Basis	$27,000	
Selling Price	43,000	
Recognized Gain		$16,000
Machine		
Adjusted Basis	$ 3,000	
Selling Price	2,000	
Recognized Loss		1,000
Residence—Recognized Loss by fire —value at time of fire...........		10,000
Excess of Recognized Gains over Recognized Losses		$ 5,000

Since the recognized gains exceed the recognized losses (treat like long term capital gain)—50% of $5,000—included as long term capital gain or $2,500. If the building in which A resided were sold at a loss it would not be grouped above since it would not be an involuntary conversion and such a loss is not deductible under the law in any event. If the fire had resulted, let us say in a $20,000 loss instead of the $10,000 indicated the recognized losses would have exceeded the recognized gains by $5,000 and the full amount of $5,000 would be deductible as an ordinary deduction and in effect the factory gain would be fully includible as income.

If in the above example the taxpayer were a corporation—then of course the question of residence would not be applicable. You could substitute any type of involuntary conversion to be grouped under (c) stated above—such as unregistered bonds stolen from the corporation and not covered by insurance. However, there would be taken into account 100% of the recognized gains and losses as the percentage provisions of 117(b) do not apply to corporations. In any event whether the taxpayer be Mr. A or the A corporation the alternative tax provisions of Section 117c(1) and 117c(2) apply where the recognized gains exceed the recognized losses.

NOTE: See citation reference 38 in relation to net operating losses, etc.

Demolition and Abandonment

Generally losses in full are permitted on a voluntary removal or demolition of a building. Intention plays a great part to determine the tax consequence in transactions of this type. Where property was purchased with intent to raze same the entire costs of the land and the old building as well as the demolition expenses are capitalized and allocated to the land.[39] Where at the time of acquisition there was no such intention to demolish but later it was decided to do so and erect a new building in its place the old building's adjusted basis must be added to the cost of new building.[40] The latest case in point—Henry Phipps Estate[41] permitted the cost of the old buildings to be added to new building costs where no demolition loss was ever claimed although it might have been claimed and there was no intention of demolishing the buildings when originally acquired. Here of course "intention" being an important factor the evidence thereof and its competency must be determined by a lawyer.

Business real estate may be abandoned and the taxpayer may take a full loss even though the taxpayer does not

[38] I. T. 3711, 1945—3—11950 p. 5.

[39] Providence Journal Co. *vs.* Broderick, 104 F (2) 614.

[40] Appelby's Estate, 123 F (2) 700; Cf. Union Bed & Spring Co. *vs.* Comm., 39 F (2) 383.

[41] Henry Phipps Estates, 5 T.C. 116.

divest himself of the title to the abandoned property. However, proof must be submitted to show a real and actual intention to abandon and also extinction of value.[42]

Involuntary Dispositions

While condemnation proceedings denotes an involuntary disposition—it is treated taxwise as if it were like a voluntary sale or exchange.[43] In these cases of course Section 117(j) may be used to advantage.

If there is a fire or similar casualty no sale or exchange is involved and of course in the usual case the full gain or loss is considered for tax purposes[44] whether or not the property destroyed is or is not a capital asset and whether or not it is business or residential property.

Illustration B

FACTS

Garage building owned by B has adjusted cost basis of $25,000 and a fire destroys same during 1945. Assume amounts of proceeds from insurance as indicated below.

B-1

Garage building adjusted cost	$25,000
Proceeds of insurance	20,000
Recognized Loss	$ 5,000

If B now erects or purchases a new garage at a cost of $34,000 that amount is the basis for the new garage.

B-2

Garage building adjusted cost	$25,000
Proceeds of insurance	30,000
Recognized Gain	$ 5,000

If B immediately erects or purchases a new garage at a cost of $34,000 no gain is recognized and cash expended in excess of insurance proceeds is added to old basis and the basis of new garage building is $29,000.

B-3

Garage building adjusted cost	$25,000
Proceeds of insurance	31,000
"Actual" Gain	$ 6,000

If B uses $27,000 to erect a new garage *gain* to the extent of the unexpended balance of $4,000 is *recognized.* New garage basis determined as follows: [Section 113(a)(9)]

Adjusted basis old garage	$25,000
Amount received and not expended —deducted	4,000
	$21,000
Gain recognized on conversion—added	4,000
Basis of new garage	$25,000

Incidentally the proceeds from use and occupancy insurance should be considered taxable income although there have been conflicting decisions in the relation to these matters.[45]

The code—section 112(f) gives a taxpayer certain rights relating to involuntary conversions and replacement funds which result in no taxable gain. However, exact compliance with said section and regulations is essential. As recently as October 15, 1945 the Supreme Court denied certiorari in several cases involving this section of the law. These cases must be read in detail to understand all the applicable laws involved.[46]

Mortgagors and Mortgagees

Foreclosure sales are considered as a "sale or exchange" for tax purposes.[47] Therefore a taxpayer should dis-

[42] Helvering *vs.* Gordon, 134 F (2) 685; Comm. *vs.* McCarthy, 129 F (2) 84.

[43] Comm. *vs.* Kieselbach, 127 F (2) 359; Hawaiian Gas Products Co., 126 F (2) 4 Cert. denied 317 U. S. 653.

[44] Helvering *vs.* Wm. Flaccus Oak Leather Co., 313 U. S. 247.

[45] Miller *vs.* Hocking Glass Co., 80 Fed. (2) 436, Cert. denied 298 U. S. 659; Cf. Williams Furniture Corp., 45 BTA 928; O. D. 645 3 CB 89.

[46] Winter Realty & Construction Co. *vs.* Comm., 149 F (2) 567; Flushingside Realty Co. *vs.* Comm., 149 F (2) 572; Twinboro Corp. *vs.* Comm., 149 F (2) 574; 3 above cases all C.C.A.—Second Circuit and cert. denied in all cases 10/15/45.

[47] Helvering *vs.* Hammel, 311 U. S. 504.

tinguish between capital and non-capital assets—bearing in mind, however, that even if there is a "sale or exchange" the capital gain and loss provisions of the law do not apply if the property is held to be a non-capital asset.

If the mortgagor owner of the property should give the mortgagee a deed in lieu of foreclosure—the mortgagor may have an ordinary loss instead of a capital loss if the following circumstances actually exist—(a) mortgagor not liable on bond and (b) no consideration was received for the voluntary deed. Where there is no consideration for the deed it is deemed no "sale or exchange". If the mortgagor is liable on the bond then such a voluntary conveyance gives rise to consideration since it is generally deemed that the obligation on the bond is then eliminated by merger of the mortgage into the fee. In connection with these matters see the Stamler[48] case and citations referred to therein.

In a case where only $250 was the consideration for a deed delivered to a mortgagee the Court held that sum of sufficient consideration to change a taxpayer's ordinary loss to a capital loss.[49]

In relation to a mortgagee there are many tax consequences to consider as shown by illustrations below:

Illustration C

FACTS

C holds a mortgage since 1940—face value $10,000—amortization payments reduced to $8,000 by October, 1945 when mortgagor is in legal default. C may (1) get a voluntary conveyance from the mortgagor or (2) foreclose and allow a stranger to bid in the property on sale or (3) foreclose and bid in the property on sale. In each instance below, assume the fair market value of the property is $6500.

Voluntary Conveyance to C and Mortgagor Insolvent and Deficiency Judgment Useless

C-1

Mortgage indebtedness unpaid	$ 8,000
Fair market value of property also new basis to C	6,500
Bad debt allowed C*	$ 1,500

* Unless C is held to come within provisions of Section 23k(4) relating to non-business bad debts. Latter section does not apply to corporation.

Foreclosure—Stranger Bids in Property

C-2

Mortgage indebtedness unpaid......	$8,000
Received from strangers bid—cash.	6,500
Bad debt allowed C unless 23k(4) applies	$ 1,500

Foreclosure—Mortgagee Bids in Property

C-3

Mortgage indebtedness unpaid.....	$ 8,000
Bid or purchase price.............	3,500
Amount of bad debt allowed C (subject to 23k(4))	$ 4,500
Fair Market Value of Property, also new basis to C.................	$ 6,500
Obligations of mortgagor applied to bid price	3,500
Recognized Gain	$ 3,000
Long Term Capital Gain (Re Capital Asset)	$ 1,500

In the last computation the taxpayer has both a bad debt loss as well as long term capital gain. Even though the fair market value of the property is $6,500 he bid only $3,500. The smaller his bid the greater his tax benefit, generally, for the bad debt is deductible to the extent of 100% while the long term gain is included is at 50% of the recognized gain.

The fair market value is presumed to be the purchase or bid price in the

[48] Charles J. Stamler *vs.* Comm., 145 F (2) 37 (1944).
[49] Aaron Blum *vs.* Comm., 133 F (2) 447 (1943).

absence of clear and convincing proof to the contrary and proof may be submitted to show that the value is other than bid price.[50] In connection with this matter the case of Korth vs. Zion's Saving Bank[51] must be read. The mortgage in that case was foreclosed, the mortgagor bank bid in the property for $53,500 which was the approximate amount due on the debt and the bank acquired title to the property. On the same day the bank sold the property for $38,000 and claimed a $15,500 capital loss. The commissioner disallowed the loss and recomputed a gain of over $10,000 claiming that the basis to the bank on the sale was $38,000. Both the District Court and the Circuit Court held in favor of the taxpayer. This case also illustrates how questions of evidence have an important bearing in the result.

Beulah B. Crane Case and Related Matters

Strange as it may appear there are situations where an owner of property loses same by foreclosure and yet he has a gain for tax purposes. The adjusted cost basis of the property (because of depreciation and other allowable adjustments) may have reached an amount below the unpaid mortgage indebtedness and as a result of the foreclosure the owner has a liability cancelled which is greater than the asset value of the property foreclosed. Of course if a deficiency judgment is actually obtained against the owner there would be no gain as the liability was not cancelled. A corporation, in a case[52] decided in 1943, tried to avoid foreclosure by giving a deed in a situation where the mortgage debt was $300,000 and the adjusted cost basis of property was over $257,000. The Tax Court treated the case not as involving a cancellation of indebtedness, but as a disposition of property and the difference of about $43,000 was held to be taxable.

In connection with the foregoing let us review the now celebrated Crane case.[53] Mrs. Crane inherited improved property subject to a mortgage of over $250,000. In the estate tax proceedings the property was valued at the same amount as the unpaid mortgage. She sold the property and received $2500 in net cash from the vendee who took title subject to the mortgage. The Tax Court held that the mortgage was not part of the "amount realized" by Mrs. Crane and that she only realized $2500 for tax purposes. Furthermore, since she did not assume the mortgage debt when she acquired the property—her basis was zero and the depreciation she had been deducting prior to the sale was on the basis of the property without deducting the mortgage debt. The depreciation deduction was therefore erroneous since you cannot have depreciation on a "zero" basis. If the property were foreclosed instead of sold and Mrs. Crane realized the same $2500 there seems to be no doubt that her taxable gain would have been the same.

The implications of the Crane case are interesting. Suppose a party purchases an improved parcel for $200,000 paying only $7500 in cash and taking subject to a mortgage of $192,500, said mortgage not being assumed. If $50,000 is allocated to the land value and $150,000 to the building value the depreciation rate would be 3⅓% or $5,000 per annum if it is agreed that the building had an estimated remaining life of 30 years. If we follow the Crane case to its logical conclusion then the taxpayer who has only a $7,500 equity in the property—could only deduct

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[50] Regulations 111, Section 29.23 k3.

[51] Korth *vs.* Zion's Savings Bank & Trust Company, 148 F (2) 170 CCA 10 (1945).

[52] Lutz & Schramm Co., 1 TC 682 (1943); Cf. Ernest Kern Co., 1 TC 249 (1942); Cf. Estate Markham, See note 10, supra.

[53] Beulah B. Crane, 3 TC 585, April 7, 1944; Being appealed by Commissioner to Second Circuit Court of Appeals.

depreciation for the first year and one half when his adjusted equity basis would become "zero". If amortization payments are required by the mortgage and the taxpayer makes a substantial amortization payment then all kinds of possibilities may arise. Must the taxpayer assume the liability under a mortgage before being allowed to consider the mortgage as part of the "basis" of the property? Since in the mayority of realty transactions property is purchased subjected to a mortgage rather than by an assumption thereof the taxpayers may in the future only be permitted a depreciation allowance on the basis of their equity in the property. There are also other possible implications from the Crane case and it would be interesting to see what the Circuit Court decides on the Commissioner's appeal in this case especially since two judges of the Tax Court dissented.

Settlement of Mortgages for Less Than Face Value

Generally where a creditor "gratuitously" forgives a debt the forgiven amount is not taxable income whether or not the debtor is solvent or insolvent.[54] Where, however, the settlement is not gratuitous and we have the situation of a mortgagor who is personally liable on the bond the following should be considered.

Illustration D

FACTS

D purchased property for $50,000 paying $15,000 cash and giving a first mortgage of $35,000 on which he is personally liable. During the taxable year mortgage was settled for $30,000 in cash.

D-1

If at the time of the settlement the value of the property was equal to or in *excess of the mortgage debt* D realizes taxable income. Thus if the property was worth $35,000 at that time D has a gain of $5,000 and the basis of his property still remains at $50,000. See the Coddon case.[55]

D-2

If at the time of the settlement the value of the property *was equal to or less than the settlement price* D realizes no taxable income. Thus if the property was worth only $30,000 at that time D realizes no taxable income but the basis of his property is reduced by the $5,000 saved and the basis now becomes $45,000.

D-3

If D paid originally $50,000 for the property and no mortgage debt was incurred in connection with the acquisition of the property but thereafter D borrowed $35,000 and become liable on the mortgage bond and if during the current taxable year the mortgage was settled for $30,000 D would realize taxable income of $5,000 and the basis of the property would remain at $50,000 regardless of the value of the property.[57] If D was not personally liable on the mortgage debt no taxable income would result in any case but the basis of the property would have to be reduced by the $5,000 saved.[58]

Miscellaneous

In connection with non-taxable exchanges relating to Section 112 (b) (1) of the code it is necessary to distinguish between an exchange and a sale. To constitute an exchange there must be a reciprocal transfer of property as distinguished from a transfer for a

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[54] Helvering *vs.* American Dental Co., 318 U. S. 322; Cf. Detroit Edison Co. *vs.* Comm., 319 U. S. 98; Cf. George Hall Corp., 2 TC 146.

[55] Coddon & Bros., Inc., 37 BTA 393.

[56] Hirsch *vs.* Comm., 115 F (2) 656; See also Helvering *vs.* Killian Co., 128 F (2) 433.

[57] Frank et al *vs.* U. S., 131 F (2) 864; Cf. Kirby Lumber Co. *vs.* U. S., 284 U. S. 1; Also consider possibility of Sec. 22 (b) 9 applying.

[58] P. J. Hiatt, 35 BTA 292; Fulton Gold Corp., 31 BTA 519.

money consideration only. The fact that a purchaser pays cash in addition to giving up his own property does not prevent the transaction from being an exchange.[59]

If a person or persons contemplate transferring realty to a controlled corporation not only must section 112 (b) (5) of the code be considered but generally also sections 112 (c) (1), 112 (e), 112 (h), 112 (k), 113 (a) (6), 113 (a) (8) and 113 (b) (2). Failure to give these legal provisions proper consideration might make an otherwise tax free transaction a taxable one.

In May, 1945 in the case of Lewis L. Fawcett[60] the Circuit Court for the Second Circuit held that in case of sale involving realty and a mortgage between brothers the loss on the transaction was disallowed in construing, Section 24 (b) of the Code. It is immaterial that the transaction was bona fide when considering the latter section.[61] A ruling has also been issued to the effect that while losses are disallowed gains on such sales are taxable.[62]

In connection with a disallowed family loss the basis to the new owner is cost. Assume in 1943 a father bought property for $8,000 and sold to son in 1945 for $6,000 the father is not entitled to a loss and the son's basis is the $6,000 cost to him not the $8,000.

Section 44 of the Code generally permits the reporting of income on the installment plan where realty is sold regardless of the selling price ($1,000 limitation refers to personally) but the "initial payment" during any taxable year must not exceed 30% of the "selling price". The technical meaning of these terms as well as "contract price" must be studied. There must be at least one payment during the year of sale. Thus if in 1945 a contract is entered into but the first payment is not received until 1946 the installment section of the law cannot apply. In addition it is well to remember that the section applies to gains only—not losses—and also the taxpayer may use the benefits of the capital gain and loss provisions of the law. The profit is taxed under the law in effect the year the profit is reported not when the original sale was made.[63] Also the question of whether title does or does not pass to the buyer is immaterial.[64]

Caution must be exercised in matters involving Federal tax liens and real estate titles. Sections 3670 to 3678 of the Code indicates that liens for unpaid Federal taxes are not valid against a purchaser, mortgagor or judgment creditor unless notice of lien is properly recorded. However, it appears that liens for unpaid estate and gift taxes per Sections 827 and 1009 respectively are effective for ten years apparently without demand assessment or record.[65]

Conclusion

Section 129 of the Code refers to acquisitions for the purpose of obtaining deductions, credits and allowances. Where a taxpayer owns and operates, income producing realty, at a net loss, he may acquire other property with a net income yield and on the consolidation of the operations very little or no tax may result. It is believed that Section 129 does not apply under such circumstances.

Personal holding companies were exempt under the excess profit tax laws and in many instances such corporations desired to retain such a taxable status. Now that the excess profits laws have been repealed (as of January 1, 1946) such companies may deem it advisable

[59] Hamilton, 30 BTA 160; See also Detroit Egg Biscuit & Speciality Co., 9 BTA 1365.
[60] Lewis L. Fawcett *vs.* Comm., 149 F (2) 433.
[61] Lakeside Irrigation Co., 128 F (2) 418; Cert. denied 317 U. S. 66.
[62] IT 3334 CB 1939—2 p. 180.
[63] Snell *vs.* Comm., 97 F (2) 891.
[64] Regulations 111, Sec. 29.44.2.
[65] Detroit Bank *vs.* U. S., 317 U. S. 329.

to acquire large rental producing properties so as to change their status by getting the rents to constitute "50 per centum or more of the gross income," per Section 502 (g) of the Code.

In connection with the sale of realty by a corporation all the implications and dangers of the Court Holding Company case[66] should be carefully considered. In the latter case the company, a Florida corporation, negotiated to sell an apartment house at a profit and an oral agreement was reached with the vendee. Before the agreement was reduced to writing the lawyer advised his taxpayer client of the possible double taxation in the event of the sale and subsequent corporate liquidation. Thereupon the plans were changed and the corporation was liquidated and the individual stockholders carried out the sale in proper legal form. The Supreme Court held the Corporation was liable for the tax even though under Florida law an agreement to sell real estate is not enforceable unless in writing. The Court also cited the Dobson case, supra.[2]

Thus it is seen that the ordinary law of contracts and property are not necessarily followed in tax cases as was stated in the introduction of this topic —in the case of Helvering vs. Hallock, supra.[1]

[66] Court Holding Co. *vs.* Comm., 324 U. S. 331.

Recent Significant Changes in Federal Order 27

By Sidney C. Winton

This is the text of an address given before a meeting of the Society's Committee on Dairy Industry Accounting at the office of the Society, 15 East 41st Street, on October 31, 1945.

SINCE September 1, 1938 the purchase by handlers from farmers of milk eligible for sale in the New York Metropolitan Marketing Area has been regulated by an order issued by the Secretary of Agriculture under the authority of the Agricultural Marketing Agreement Act of 1937. This order, which is known as Federal Order No. 27, has been amended from time to time—most recently on May 16, 1945 effective August 1, 1945.

Furthermore, pursuant to the authority granted by these recent amendments, the market administrator (who is the official administering the order) has for the first time issued a set of rules and regulations governing the details of accounting under the order.

It is my purpose tonight to discuss the principal changes made by the recent amendments as fully as is possible in the limited time available. Of course, in appraising today these changes we are more or less confined to the words of the changes and to the explanatory statements issued by the officials of the Department of Agriculture.

I assume most of you are familiar with the general outlines of Order 27.

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In substance, it sets up a classified pricing system for milk and an equalization pool so that all producers, that is farmers, covered by the order get the same basic price for milk.

Perhaps I should stop a moment to explain more fully what is meant by a classified pricing system. The order sets up various classes in which milk may be utilized and fixes different minimum prices to be paid by handlers to farmers depending upon the class in which the milk is utilized. Milk used as fluid milk is designated as Class I and commands the highest price. Milk which is separated into cream is, with certain exceptions, designated as Class II-A and commands the next highest price. There are also many other classifications covering milk or cream used for various specified purposes such as evaporated milk, condensed milk, butter and frozen desserts, and these classes commend lower prices.

Basically, the reason for a classified pricing system is the problem of surplus production. In this milk shed, because of current dairy techniques, there is a flush season of milk production which usually begins in April and continues through June of each year, and a short season of milk production which usually begins in October and continues through December of each year. The number of cows which are necessary in order to supply the fluid milk requirements of the metropolitan area in the short season produce a great surplus of milk in the flush season. The disposition of the surplus milk, unless regulated, is a factor which can and has in the past often utterly demoralized the milk market.

There are also other factors which enter into the problem. In order to sell milk in the metropolitan area (and I shall for brevity here refer particularly to New York City which is the largest part of the market), the dairies and the plants must be inspected and approved by the Department of Health.

The requirement of such health approval gives producers who have the approval a virtual monopoly of the metropolitan fluid milk and cream market. There are, however, no similar health restrictions on most other manufactured products such as butter, cheese and evaporated milk. These latter products may be shipped into the metropolitan market from plants and sources not subject to metropolitan health inspection and approval. There is thus open competition with the Midwest as to these products.

It is also the fact that production costs in the Midwest are lower than they are in the New York milk shed. In consequence, manufactured products made from Midwestern milk sell at a price which realizes a lower net return to the farmer than milk sold for fluid milk and cream.

It was to meet these conditions that the classified pricing system was evolved. In substance, milk is classified and priced in each class of use on a basis which will enable the New York dairy industry to meet the competition of Midwestern operators. To illustrate, milk used in making cheese or butter is priced low enough to enable a manufacturer of cheese or butter using New York milk to sell his product in competition with a manufacturer of cheese or butter using Midwestern milk.

The other major consequence of the attempt to solve the surplus problem is the equalization pool among producers which is set up by Order 27. While the mechanics are somewhat complicated, in effect the class prices payable for all milk bought from producers each month are averaged and the resulting average price, known as the uniform price, is paid to all producers alike subject to certain butterfat and transportation differentials. Each producer thus gets the same basic price for this milk irrespective of the particular uses to which his milk is put. This prevents destructive competition among producers for particular outlets and distributes the burden of the surplus equitably over all producers.

For a handler who is in the equalization pool there are great benefits. Competitive conditions make it necessary today for all handlers to pay farmers at least the uniform price for milk. During the flush season the uniform price is invariably higher than the price of many of the lower classes in which surplus milk must be utilized. Handlers in the pool are reimbursed by the pool for the difference between the uniform price which they have paid the farmers and the lower prices of the class utilizations to which they have put the milk. In other words, the pool carries the burden of the surplus. This is particularly important during the flush months when there is a large surplus.

As I stated at the outset, Order 27 regulates prices paid to farmers for milk eligible for sale in the New York metropolitan area. This was originally accomplished through the inclusion in the pool of all milk received from producers at plants which were approved by any health authority for the receiving of milk to be sold in the marketing area. For the sake of brevity, I shall again refer to the New York City Health Department as if it were the only one involved, although approval by any other health authority having jurisdiction in any part of the marketing area would formerly have been sufficient to bring a plant into the pool.

Prior to the amendments, any plant whose health approval was revoked was automatically excluded from the pool and likewise any plant receiving health authority was automatically included in the pool. This gave the health department the power to determine in effect whether or not a plant should be included in the pool with important

economic consequences as distinguished from the purely health considerations which alone should influence health officials. There was considerable fear that some health officials might act with an eye to such economic consequences rather than purely from the standpoint of health.

For instance, some time ago the Department of Health began a study looking toward the reduction of the size of the New York milk shed and the cancelling of health approval of the more distant plants. This investigation grew out of the fact that many plants with New York City approval rarely if ever shipped milk into the city but by virtue of their health approval were obtaining all the benefits of the equalization pool. These plants were thus having their surplus carried by the pool in the flush months but were not supplying fluid milk to New York City in the short months. This was one of the considerations—probably one of the principal considerations—which prompted the city to promulgate the 60% rule under which the city undertook to cancel the approval of any handler who did not ship 60% of his receipts into the city during the short season.

The revised order makes a direct attempt to solve these various problems. It no longer makes inclusion in the pool dependent *per se* on health approval. It imposes sanctions on handlers who do not ship specified percentages of their milk into the city during the short season; and it seeks to prevent any operator from obtaining the benefits of the pool during the flush season while avoiding the burdens of the pool during the short season.

These are the basic considerations underlying the somewhat complicated provisions of the order dealing with pool plants.

The amended order now provides for two different types of pool plants: (1) reserve plants; (2) plants shipping fluid milk into the marketing area.

These categories corresponded roughly to plants whose production is necessary only for the short season and those whose production goes into the metropolitan market all year round.

Reserve plants, the first category, are designated by the Market Administrator on annual application. They must be willing to ship fluid milk into the marketing area and must have no commitments which prevent them from shipping 75% of their milk into the marketing area during the months of August through December, or during any month in which the Secretary of Agriculture has declared an emergency. A handler need not, however, ship more than the average percentage shipped into the marketing area by all handlers during any month in question.

These provisions are intended to exclude from the pool a reserve plant which fails to ship an adequate amount of fluid milk into the metropolitan area during the short season.

In order to prevent the possibility of health officials attempting to regulate the economic side of the milk business, the order makes health approval no longer a *sine qua non* or a reserve plant. A plant may now be admitted into the pool as a reserve plant even if it has no health approval, provided it had health approval during the preceding October, November and December, and keeps such control over sanitary conditions that the plant could meet the health requirements.

The second category of pool plants is plants shipping fluid milk into the marketing area. Such plants become pool plants for any month during July through March in which they ship to the marketing area 25% of the milk which they receive, and for any month during April through June in which they ship 10%.

In order to prevent such a plant from coming into the pool only during the flush season, it is provided that no such plant shall be included unless it has shipped into the marketing area 60% of its receipts during the preceding short season, i.e., October, November and December.

The same problem is covered as to reserve plants by a provision that reserve plants may be admitted into the pool only in August, i.e., after the flush season, and can withdraw from the pool only in the months of April through July, i.e., during the flush season.

For the immediate present, these elaborate provisions as to pool plants are rendered to some extent theoretical by what is known as the carry-over designation. This provides that all plants which participated in the pool on November 1944 are automatically designated as reserve plants until such designation is cancelled for failure to live up to the obligations of a reserve plant. In the future, however, it is likely that these provisions of the order will take on greatly increased importance. I may add parenthetically that, since this paper was prepared, a considerable number of plants have been suspended by the market administrator for failing to live up to their obligations to ship the requisite amount of fluid milk into the marketing area.

The new pool plant provisions contemplate that a situation may arise where a plant approved by health authorities for the shipment of milk into the marketing area will not be a pool plant—a condition heretofore impossible. This situation is the occasion for the inclusion in the order of the so-called penalty payment provision. This section of the amended order provides that when milk is shipped into the marketing area from a non-pool plant as fluid milk or cream or skim milk, certain payments must be made into the pool by the first handler receiving the milk who is subject to Order 27, or if there is no such handler, by the handler shipping to the metropolitan purchaser of the milk.

The penalty payments are in substance a protective tariff. No part of the payments goes directly or indirectly to the farmers who produced the milk in respect of which the payments are made. The entire benefit goes to the farmers delivering to pool plants. There is, therefore, room for doubt as to the legality of this provision under the Agriculture Marketing Agreements Act, but it is impossible to express a definite opinion in view of the known reluctance of the courts today to interfere with administrative action.

The next group of significant changes in the order concerns the classification of milk.

Basic to Order 27 until the recent amendments was the principle that milk was to be classified at the plant where received from producers except that, if moved to a second plant as milk, it might be classified at the second plant and, if there separated into cream which was moved to a third plant, it might be classified at such third plant. This may be summarized by saying that for classification purposes one plant movement was permitted in the form of milk and one in the form of cream.

There was a two-fold basis for these restrictions—one was the supposed difficulty as a matter of auditing in following milk through an indefinite series of movements; the other was the desire to prevent the uneconomic and wasteful movement of milk. Experience, however, has apparently shed further light on these matters. It has been found necessary to audit fully the records of every pool plant. And it is apparently believed by the Department that the economics of the situation alone is for the most part enough to prevent uneconomic movements, at least between pool plants.

In consequence, the amended order now permits unlimited movements among pool plants in the milk shed with classification presumably at the last plant.

On the other hand, since non-pool plants are not covered by audit as fully as pool plants, the old restrictions are with some modifications continued as to movements to non-pool plants. Thus, milk which is shipped to a non-pool plant is classified there regardless of the number of prior pool plant movements unless it is there separated or condensed

and shipped to another plant, in which event it is classified at such other plant.

There are a series of important exceptions to this rule, however, which in substance prohibit lower classifications which might otherwise be warranted by straight class utilization. These also impose a 65-mile limitation on certain plant movements which has been justified largely because of the expense of sending auditors to distant non-pool plants, although also intended to eliminate to some extent uneconomic movements of milk.

Another change made by the order is the liberalization of the period within which classification must be established. As under the old order, the temporal basis of accounting remains monthly receipts from producers; but the period to use the receipts and establish the classification thereof is extended from eight days after the end of the month of receipt to the end of the month following receipt.

A major change has been made in the handling of plant loss. The old definition of Class I milk provided in effect that plant loss not to exceed 2% of the total milk received might be prorated to each class of utilization, any excess plant loss to be classified as Class I.

It should be noted, parenthetically, that the plant loss question is one of how to classify and pay for plant loss; and that the plant loss allowances do not mean that the handler is in any way freed from the obligation to pay fully, for the milk lost in plant operations.

Under the old order no account was taken of any specific manufacturing or other operation. A flat overall allowance of 2% was granted, irrespective of whether the plant was engaged only in receiving and shipping milk from farmers or in making cream or churning butter or otherwise. Obviously, it was only a very rough approach, since the more manufacturing operations there are, the greater the plant loss.

The new order provides:

> "Allowances for plant loss not to exceed 5% of the butterfat in the product resulting from any specific plant operation * * * may be classified the same as * * * the butterfat in the product.

It also provides that specific allowances shall be determined by the market administrator by rule or regulation.

Pursuant to this authority, the market administrator has fixed in the rules and regulations the specific percentage of plant loss allowed on each type of operation. This is a far more sensible procedure than the old one and I believe will work more satisfactorily.

Another group of significant changes in the order deals with accounting procedure. Subject to certain general principles announced in the amended order, this subject is left to the rules and regulations of the Market Administrator. These are very complex and deal with matters particularly in the domain of accountants and a lawyer would have to be bold indeed to discuss them here tonight. I shall, however, touch briefly on the underlying theories of these provisions.

The order provides:

1. Milk, cream or skim milk received from pool sources is to be assigned, as far as possible, to Class I, II-A or V-A uses of the handler.

This means in general that the pool gets the benefit of the higher class uses of the handler, even though he actually happens to use non-pool milk for the higher utilizations. On the other hand, this does not work entirely against the handler, because the higher classifications may entail penalty payments on non-pool milk and these may be avoided by the allocation.

2. If milk, cream, plain condensed milk or skim milk is received from pool sources and also from non-pool sources in like form, it is to be assigned pro rata to the total classifications of all milk after the above assignment of pool milk to the higher classes.

These provisions of the order attempt to do away with what is known as proof of specific use by providing a more or less arbitrary method of assigning milk and butterfat receipts to different class utilizations at the plant. The related provisions of the rules deal with the same problem but also have interwoven in the same accounting procedure provisions for classifying plant loss on the basis of specific plant operations.

The rules attempt, as I have said, to establish the principle that a specific lot of milk cannot be classified in a particular class merely because it can be established by evidence that it was so used. Classification will be entirely dependent on the arbitrary assignment procedure established by the rules and regulations. This can, prima facie at least, a far cry from the provision in the agricultural Marketing Agreements Act, which is the sole legal basis for Order 27, that milk may be classified in accordance with the purpose for which it is used.

Be that as it may, by these rules the Market Administrator has avowedly attempted to abolish once and for all the principle of specific use which he has often contended leads to great auditing difficulties. The principle of specific use, however, dies hard and leaves many traces even in the present rules. For instance, in Section 2(t) of the rules it is stated that butterfat received in the form of sour cream is to be deducted from other products leaving the plant "to the extent that the handler claims utilization of sour cream in the manufacture of such cheese or butter". Similar provisions may be found in many of the other subdivisions of Rule 2.

What I have said with respect to these various changes has necessarily been sketched in broad outline and even in broad outline is difficult to follow because of the highly technical nature of the subject matter. There are many limitations and qualifications contained in the amended order which, though most important in practice, cannot be discussed in the limited time available tonight. It seems clear, however, that the recent changes in the order on the whole reflect a closer adjustment of the order to the problems of the milk shed. Particularly the promulgation of rules and regulations by the Market Administrator is a vast improvement over the former practice under which these rules were not made public but were embodied in office instructions to field auditors which could be discovered by the handler only by induction from the results of the audits of his records.

Finally, it is clear that here, as in other fields of law, the full implications of the changes will only become apparent as the market lives under the amended order and as the problems which arise from actual experience, are struggled over and solved. The whole story can never be found in the mere words of the law or of the rules and regulations.

The Function of the Accountant in Relation to the New York Milk Marketing Order

By Louis H. Sherman, C.P.A.

This is the text of an address given before a meeting of the Society's Committee on Dairy Industry Accounting at the office of the Society, 15 East 41st Street, on October 31, 1945.

After seven years of experience under Federal Order No. 27 (and its companion New York Order No. 126), regulating the New York Metropolitan Milk Marketing Area, there is no one who entertains any doubt about the permanency of the Order, in the absence of any presently unforseeable and fundamental changes in milk production or marketing conditions. And, I may venture to add, there is no responsible member of the New York Milk Industry (including producers and distributors of milk) who would desire the termination of the Order. There is almost complete unanimity in the opinion that the Order has contributed materially to the stability of milk marketing in this area; and there are many who believe that the promulgation of the Order in 1938 had averted chaos in the Industry.

If we accept these opinions and beliefs, then it is well for the accountant, associated with the handling of milk and dairy products, to re-examine the basic principles of the Order and his functions in relation to it. The greater part of our experience under the Order has been during wartime, when the accounting profession and business offices were deluged with an almost endless flood of governmental questionnaires and report forms. It is, therefore, hardly surprising that many of us have fallen, to some degree, into the bad habit of completing forms with a minimum of study and without critical examination. I need hardly observe that the accountant's function extends far beyond the preparation of operating summaries and routine forms for submission to the Market Administrator. In the proper discharge of his duties, the accountant must thoroughly understand the fundamental purposes which the Order seeks to achieve. He should inform himself fully with regard to all of the economic considerations involved in the Order and be able to judge the soundness of its provisions in the light of the needs of the entire Industry. The need for an Industry viewpoint cannot be too strongly stressed. A temporary advantage gained by an individual or group from an inequitable provision of the Order cannot long endure, and, in the end, may prove costly. The short-lived benefits which some milk handlers derived from the much abused Market Service or Diversion Payment provision of the Order resulted in long and costly litigation; and the term itself has fallen into such disrepute as to impede and delay any intelligent discussion of a program to facilitate the movement of milk into channels most beneficial to the entire Industry. The accountant must be prepared to cooperate with other handlers, producers and governmental authorities in efforts to conform the Order to the best interests of the Industry, and, to that end, should be prepared to submit the best available data regarding the production, handling and

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marketing of milk and dairy products. At the same time, he must be prepared to interpret every provision of the Order in the light of the operations of his own client or principal and must assume responsibility for the maintenance of a system of accounts and reports which accurately reflect the handler's operations and enable him to avail himself of every permitted benefit and advantage under the Order.

What, then, are the fundamental objectives of the Order? The marketing and handling of milk and its products presents two difficulties which are inherent in the nature of the product: first, its perishability; and second, the seasonal variations in the volume of its production. With volume of production in the flush Spring months in some parts of the Milk Shed as much as three times the volume in the short Autumn months, there was a critical need for devising some means for orderly disposition of the surplus in a Production Area basically tied to a fluid market. Obviously, the producer could not hold back his perishable milk crop, nor could the handler pay for his surplus at the prices which he was able to pay for that portion of the milk sold in the fluid market. The Classified Price Program was the obvious solution to this problem. Under this program, handlers could provide outlets for all milk produced (within the limits of their manufacturing facilities) and could return to their producers a price for surplus milk commensurate with its value in manufactured dairy products markets. Classified Pricing long preceded the Order and was merely incorporated into it.

But Classified Pricing presented a further problem. The seasonal variations among different producers was not uniform. Fluid requirements of various handlers and their manufacturing facilities differed greatly. Thus, the weighted average price which different handlers could pay varied greatly. From this situation, a greater evil arose. Competition developed among handlers on the basis of the weighted price paid by each to their respective producers, without regard to the true or basic price actually paid for each class in which milk was utilized. Individual farmers, very naturally, were interested in the return on their total milk production and not in the mechanics of computation of the price under a Classified Price Program. As a result, a shrewd and often not too scrupulous handler could purchase milk for fluid purposes at a drastically reduced price by paying a little more than his neighboring handler's fairly computed blend prices. As a consequence, the fluid milk market, the primary market in this Production Area, was easily disrupted, to the detriment of producers and handlers alike. To overcome this problem, equalization of cost to handlers and returns to producers was offered as a solution. Classified Pricing and Equalization are the foundation of the Order. All handlers pay equally for each class of utilization and through the medium of an equalization pool, pay a uniform blend price to their producers. In the absence of these two basic programs, Classified Pricing and Equalization, producers would either be without markets or at the mercy of unscrupulous handlers and reputable handlers would be powerless to compete, thereby leading to the destruction of the entire market.

The Federal Order, in its present form, provides for 12 classes of butterfat and two classes of skimmilk utilization. An attempt is made to relate the price of each class of utilization to the market value of the product, although, in some cases, the formulae prescribed are admittedly arbitrary. Thus, the price of milk used in the manufacture of cream for the Boston and Philadelphia markets is related to the quotations for cream sold in those markets; the price for milk used in the manufacture of evaporated milk is related to the prices paid for milk by selected Mid-Western condenseries to their producers (that section of the country be-

ing the outstanding manufacturing center for such products); and the prices for milk used in the manufacture of butter and cheddar-type cheese is related to market prices of those products. The price of skimmilk used in the production of manufactured products is related to the market value of roller process dry skimmilk. (Incidentally, the pricing of skimmilk, separately from the butterfat value of milk, represents a departure from historic practice and was largely the result of the meteoric rise in the value of nonfat milk solids, occasioned by the war). There are many difficulties inherent in the establishment of formulae for determination of class prices, such as the determination of true market values, manufacturing costs, yields and transportation costs. Differences of opinon exist with regard to the validity of some of the factors employed, and it has been argued that some of these formulae prohibit the manufacture of some products in this area, thus shutting out producers from profitable markets. Thus, it has been maintained that the transportation differential included in the Class III price formula actually bears no true relationship to the difference in the cost of transporting evaporated milk to the Atlantic Seaboard and that this and other factors will tend to entirely stop the production of evaporated milk in this area. Furthermore, it is claimed that the production of dry whole milk cannot continue in this area under a formula which maintains the same transportation differential for that product as for evaporated milk. Thus, while the fundamental principles of Classified Pricing and Equalization are relatively simple, their translation into workable price formulae is beset with many difficulties. Here, indeed, is a rich field for the application of the talents of the accounting profession. Nor should it be supposed that the question of proper pricing of manufactured milk products is of concern only to the handler engaged in their manufacture. Every milk handler, even though such handling be limited to fluid milk, is vitally affected by this question, since the stability of the entire market depends on the proper pricing and channeling of surplus milk.

A great part of the confusion with respect to the Order has arisen from the incorporation within it of principles which, while necessary, are secondary to the fundamental purposes of Classified Pricing and Equalization. While I am determined to avoid controversial matters in this paper, I must make some observation about the departure from the fundamental principles of Use Classification. The Act of Congress under the authority of which the Order was promulgated contains the fairly simple provision that milk shall be classified "in accordance with the form in which or the purpose for which it is used". It soon appeared that certain limitations had to be placed on the principle of Use Classification in order to protect the interests of producers and because of administrative necessity. Nevertheless, there are certain provisions of both the Order and the Rules and Regulations, issued under the Order, which appear to be inconsistent with this fundamental provision of the Act. And so, minor exceptions, which were placed into operation by administrative interpretation, rather than by clear provision of the original Order, have been broadened into such complete departures from the principle of Use Classification, that one wonders about the authority for such provisions, even when he is able to understand and approve their purpose. The clearly expressed exceptions to the basic principle present a problem for the lawyer rather than for the accountant. But, in many instances, the denial of the right to classify on the basis of actual use came by administrative interpretation. While, in such cases, the justification often advanced has been the claim of administrative necessity, very often the handler was told that use had not been sufficiently proved or established.

It is in connection with this point that the accountant exercises a most necessary function, and upon him rests the responsibility for establishing proof of use. But the establishment of use of milk or butterfat in a given product involves the establishment of a system of records and reports designed to accurately reflect the nature of the operations, quantities of milk and butterfat used, quantities and butterfat content of products made, movements, inventories, etc. During the meeting recently held by the Market Administrator, to consider proposed rules and regulations, there was much discussion on the subject of classification of products, destroyed by fire or otherwise. While the Industry's proposal was rejected, there was an indication that under certain circumstances, the Market Administrator would permit the classification of milk on the basis of its manufacture into a product which was subsequently destroyed. Within the limitation of the paper, I dare not undertake to suggest any specific accounting procedure. (Indeed, such suggested procedures should result only from the concerted study of the best technical experts in the Industry and would require considerable space for their presentation). But it may be observed that, if any issue should arise with respect to the classification of milk used in the manufacture of products subsequently destroyed, that a well-maintained system for recording all details of manufacture may be of the greatest help.

But, of course, the accountant's function covers a wider field than establishing detailed records of use and movement. A good system of accounts and reports can prove beneficial in numberous other respects. To illustrate, it will be recalled that the Order, as amended effective August 1, 1945, for the first time penalizes the handler who accounts for an excess of butterfat, as well as the handler who reports an excessive loss. During some recent discussions with members of the Industry, I learned that problems have already arisen under these provisions of the Order. In the case of one handler who maintained a complete system of reports and accounts, it was possible to explain an overage in terms of faulty inventory reporting and in addition, to clearly establish the propriety of correcting an earlier report where an apparent excessive loss had been reported. In another case, involving a reputable handler who was guilty of no wrongdoing, penalties were paid despite the fact that there appeared to be a definite relationship between an excessive plant loss reported in one month, and an overage reported in another, because of lack of adequate accounting proof.

But no system of accounts and reports can be established merely on the basis of theoretical considerations. On too many occasions, accountants (governmental as well as those representing handlers) have seemed to indulge in the belief that the plant is an adjunct to the accounting department and have lost sight of the fact that the primary purpose of a milk plant is to handle milk and not to prepare accounting reports. In many cases, unascertainable information has been demanded because of the accountant's lack of familiarity with the plant's operations. To illustrate, a plant receiving milk from producers, which milk is pumped directly into various manufacturing operations, may not be able to determine accurately the quantity and the butterfat content of the milk going into each operation. Nevertheless, field auditors and milk company accounting departments have asked milk plant operators to report exact quantities in such cases. Obviously, any figure so reported must be based on conjecture. I entertain no fundamental objection to the use of estimates where necessary. But where estimated figures are used, such estimates should be made in the accounting office and should be disclosed to be merely estimates rather than definitely ascertained quantities. I have known of a case where skimmilk recoveries

have been reported on the basis of estimates, where it was obvious that no exact figure could be furnished because of the mechanical setup of the plant. Nevertheless, despite obvious error in estimating, such figures were used, often to the serious disadvantage of the handler. In many cases, information could be obtained only at an unreasonable cost, entirely out of proportion with the nature of the operations. The accountant has the responsibility of familiarizing himself with the nature of the operation in order to determine which information is readily available and the difficulties involved in obtaining other information.

I earnestly believe that no accountant can satisfactorily discharge his obligations to his client or his principal without careful study of how the milk is handled at the plant. I could prepare an almost endless list of the matters with which the accountant should familiarize himself and in connection with which he should establish a system of accounts and reports, designed to assure most advantageous treatment under the Order. He should collect and interpret all data with respect to yields and manufacturing costs in order to properly weigh the soundness of the pricing provisions. He should know competitive conditions in local, nearby, and distant markets, and transportation costs for the same purpose. He should assemble data with respect to the marketing of milk products to help test the soundness of the various limitations on movements concerned in the Order. The provisions for allocation of classication between pool plants and non-pool plants, and the penalty provisions respecting milk, cream, or plain condensed milk, moved into the market from non-pool plants, have created new fields for study on the part of the accountant. It was generally agreed that the loss tolerances established in the new Rules and Regulations were tentative and subject to further study. The accountant should be prepared to present clear and convincing proof regarding the adequacy of these allowances. The conversion factors set forth in the Rules and Regulations should be carefully considered and weighed in the light of data which the accountant should gather and check carefully. I could continue this enumeration almost endlessly.

I realize, however, that no accountant can accomplish many of the desired results by himself. Joint study and exchange of ideas are not only helpful, but, in many cases, are the only means of properly acquiring necessary information and data. Trade associations have accomplished a great deal in assembling necessary evidence in preparation for hearings. Often, however, such work has been hurried and conducted under pressure within a relatively short time before the hearing date. I feel that permanent technical committees to study current problems should be established and should meet regularly for frequent exchange of ideas and discussion of problems. Joint meetings should be held between trade association committees and technical committees of the accounting societies. Study should be leisurely and thorough and should not be hampered by deadlines.

In many instances, the accountant is at a serious disadvantage. Without previous study of the technology of milk handling and, often in the face of other and more pressing problems, he is suddenly precipitated into a complex problem involving milk handling, manufacturing, or marketing. In many of these cases, he has not had the opportunity to familiarize himself with the basic facts regarding the plant operation. It appears to me that accounting for milk handlers has become so highly specialized a field, that it requires most thorough preparation and study. I would urge most strongly that agricultural and accounting colleges establish special courses of study in their undergraduate or graduate departments for students or practicing accountants who wish to specialize in dairy accounting.

A curriculum covering such subjects as milk production, milk handling, manufacture of dairy products, milk and dairy products marketing, milk chemistry and bacteriology, testing for butterfat and milk solids would better prepare the accountant for the discharge of his responsibilities. Finally, I would urge cooperative study of their common problems by accountants representing producers, handlers and governmental agencies. The recent meetings called to consider the proposed Rules and Regulations bore striking proof of what we may expect from such joint effort.

C. P. A. Examinations given by the University of the State of New York

November 7, 8, 9, 1945

100TH ACCOUNTANT EXAMINATION

PRACTICAL ACCOUNTING—Part I

Wednesday, November 7, 1945—1.30 to 6 p. m., only

The Practical Accounting paper consists of part I and part II.

State your examination number on each sheet. Do not sign your name.

Consider carefully each requirement of each problem. Designate each solution by number. Consider technic and neatness as carefully as mathematics.

Solve four problems only from the group given. Each correct answer counts 12½ credits. Indicate selection by a check mark (√) placed at the left of the number on the question paper.

1 Submit cash count working papers with appropriate notations.

You, a professional accountant, arrived at the Sunbeam Hospital on the morning of January 1, 1945, shortly before the office opened for the day.

All cash, except $20 in currency for change purposes, was locked in the safe at closing time, December 31, 1944, which was 10 p. m. The night clerk issued three receipts after 10 p. m., December 31, 1944, as follows:

Receipt No. 15803—12/31	Jeremiah Moore	$16
4—12/31	Mrs. A. B. Colton	4
5—12/31	R. A. Jones	50

In the cash drawer were two checks, of $16 and of $50; a slip for $2 marked "Advance" and signed by Martha Lowe, a student nurse; and currency of $22, consisting of 2 five-dollar bills and 12 one-dollar bills.

The cashbox in the safe contained the receipts for December 31, 1944, as follows:

Receipt No. 15788 —	$ 42	(check)
9 —	10	(cash)
15790 —	30	(check)
1 —	75	(check)
2 —	164	(cash)
3 —	40	(cash)
4 —	100	(check)
Receipt No. 15795 —	$31	(check)
6 —	50	(cash)
7 —	34	(cash)
8 —	17	(cash)
9 —	20	(check)
15800 —	30	(cash)
1 —	98	(cash)
2 —	60	(cash)

All checks in support of the receipts were in the cashbox. The following currency and coin were also in this box: 10 twenty-dollar bills, 14 ten-dollar bills, 18 five-dollar bills, 46 one-dollar bills, 16 fifty-cent pieces, 28 quarters, 32 dimes, 164 nickels, 60 pennies.

The imprest cash and change fund of $200 was kept in a separate cashbox. This fund was found to contain the following:

Express bill—drugs	$ 3.64
Receipt for hauling ashes	7.00
Postmaster's receipt—postage	20.06
I. O. U.—Agnes Monroe (nurse)	6.00
Express bill—drugs	5.34
I. O. U.—Dr. Crossett (interne)	16.00
Drugs—for patient in room 419	6.50
Daily papers for reading room	.40
Checks returned by bank:	
December 4, 1944 (N. S. F.)	30.00
December 12, 1944 (forgery)	10.00

Currency and coin: 6 five-dollar bills, 14 one-dollar bills, 18 fifty-cent pieces, 36 quarters, 68 dimes, 92 nickels, 166 pennies.

Mr. Joseph Anton is the cashier. Mr. H. Holmes is the manager.

2 Rearrange the following items in the form of a consolidated balance sheet for the city of X.

Set out these accounts in balance-sheet order so that by your solution you show your familiarity with municipal balance-sheet arrangement.

	Debit	*Credit*
Accounts payable		$ 20,000
Accounts receivable	$ 35,000	
Advanced taxes		100,000
Buildings	400,000	
Cash—bond funds	15,000	
Cash—general	35,000	
Equipment	90,000	
General city bonds		300,000
Improvements	140,000	
Investments	25,000	
Land	75,000	
Land betterments	100,000	
Maintenance material	15,000	
Public utility bonds		250,000
Sinking fund cash	10,000	
Sinking fund reserve (water dept.)	50,000	
Special assessments account	100,000	
Stores	10,000	
Supplies	15,000	
Surplus		370,000
Trust and special funds		75,000
	$1,115,000	$1,115,000

3 Compute the per pound average gross profit and net profit. Carry computations to three decimals only.

	Pounds	*Amount*
Factory expenses		$369,965.62
Finished goods, inventory, December 31, 1943	$ 290,854	84,347.66
Finished goods, inventory, December 31, 1944	283,916	
Raw material consumed	3,365,498	572,939.00
Sales	2,989,743	986,615.19
Selling expenses		31,471.87
Waste recovered		24,095.00

4 The Wear Well Trading Company was incorporated as of April 16, 1944, for $75,000, by X and Y, who previously operated under articles of partnership.

The change in organization was not taken up on the books at that time. The net worth of the partnership of X and Y, December 31, 1943, totaled $90,000.

The net loss for the year 1944 was ascertained to be $9,000, by an audit made in February 1945. No drawings were made during 1944. Business was fairly uniform during 1944. Books were closed as of December 31, 1944.

Being called upon to adjust the books in March 1945, give the journal entry or entries necessary to correct the books of this company.

5 Prepare so much of a trial balance as may be determined from the following facts:

The records of White and Snow, stockbrokers, show the following:

Bought Clearing House Blotter

Amount	*Commission*	*Total*
$300,600.00	$895.00	$301,495.00

Sold Clearing House Blotter

Amount	*Tax*	*Commission*	*Total*
$406,800.00	$402.60*	$1,005.00	$405,392.40

[* Revenue stamps, $394.40; Federal registration fee, $8.20]

The total money value of stock balances to be received on the basis of settling price is $81,200.

The total money value of stock balances to be delivered on the basis of settling price is $178,200.

The total failed to receive is $31,600, and the total failed to deliver is $62,200.

6 Set out in one table or schedule, for the Black River Finance Company, your calculation (with explanation) of the necessary increase (or decrease) in the amount of the reserve for unearned income, etc., as of December 31, 1944, the interest rate used by the company being 4%.

Utilize the information presented below:

Volume of business transacted in 1944		$2,880,000
Total 1944 income	$201,600	
Anticipated collection expenses on 1944 business	57,600	
Anticipated losses on 1944 business	28,800	
Notes receivable outstanding (including interest),		
December 31, 1944:		
Past due	40,000	
Due during 1945:		
January	210,000	
February	195,000	
March	180,000	
April	165,000	
May	150,000	
June	135,000	
July	120,000	
August	120,000	
September	105,000	
October	90,000	
November	75,000	
December	75,000	
Due during 1946:		
January	50,000	
February	40,000	
March	40,000	
April	30,000	
May	30,000	
June	20,000	
Total		1,870,000
Reserve for unearned income, etc.		40,650

THEORY OF ACCOUNTS

Thursday, November 8, 1945—9 a. m. to 12:30 p. m., only

Read each question carefully and write your answer carefully, clearly and concisely.

Be certain to number your answer to correspond with the question number and check (√) number on question paper, but do not rewrite the question as part of your answer.

You may cite outstanding authorities in support of your replies. However, you will be rated upon your own knowledge and reasoning.

Do not sign your name to the paper. State your examination number.

Answer the questions as directed under each group. Papers entitled to 75 or more credits will be accepted.

Group I

Answer one question from this group.

1 A corporation has been engaged mainly in producing war materials under government contracts. The prices and profits are subject to renegotiation.

a In which section of the balance sheet should a "reserve for renegotiation refunds" be reflected?

b In which section of the profit and loss statement should the provision for renegotiation refunds appear?

c If the renegotiation refund finally determined to be payable for any year is different from the provision made therefor in the financial statement originally issued for such year, should the difference be included in the current year's profit and loss statement or adjusted through the earned surplus account? State the reason for your answer.

2 The following inquiry was discussed by the Securities and Exchange Commission in an Accounting Series Release, issued in January 1944:

"Whether in a financial statement required to be filed with the Commission, goodwill may be written down or written off by means of charges to capital surplus. The goodwill in question resulted from the acquisition during the year of the assets and business of a going concern at a price of $2,000,000, of which $1,750,000 was paid for physical assets and $250,000 for goodwill. It is now proposed to write off this goodwll by a charge to capital surplus.

The Securities and Exchange Commission rule that the goodwill is to be written off, the charge should *not* be to capital surplus.

Do you agree or disagree with the Securities and Exchange Commission's opinion? State your reasons and indicate to what account you would charge said goodwill, if writing it off.

Group II

Answer one question from this group.

3 A business enterprise owns a truck which cost $1,000 and on which depreciation of $800 has been charged to operations and deducted on Federal income-tax returns to December 31, 1944. On January 2, 1945, the company purchased a new truck at a price of $2,000, being allowed, however, a trade-in value of $500 for its old truck.

a State the journal entries to reflect the foregoing transaction on the books of account.

b Will the above transaction result in any allowable profit or loss on the company's 1945 Federal income-tax return?

c On what fixed-asset value will depreciation be based, on the 1945 Federal income-tax return?

4 *a* What is the difference between the "reserve" method and the "write-off" method of treating doubtful and bad accounts receivable, for purposes of a corporation's Federal income-tax return?

b Assuming that a collection is made in 1945 on account of a customer's balance deemed bad in 1943, state whether this collection would be considered as additional income on the corporation's 1945 income-tax return under:

(1) The reserve method

(2) The write-off method

Group III

Answer eight questions from this group.

5 Explain and define *each* of the following terms relating to inventory valuation methods:

a Life

b First-In First-Out

c Retail inventory method

d Cost or market, whichever is lower

6 A corporation constructed and fully furnished a hotel, which it has operated for three years. During the current year, the following transactions took place:

a New beds and chairs, aggregating $6,000, were purchased for guest rooms.

b The grand ballroom was repainted and redecorated at a cost of $2,000.

c The outside walls of the hotel were sandblasted and cleaned at a cost of $3,000.

d Additional bookkeeping machines were purchased for the hotel office at a cost of $900.

e A section of the main lobby was remodeled and reconstructed to provide several stores, which were then leased at a rental of $5,000 per year. The cost of this alteration was $10,000.

Indicate for each of the foregoing expenditures whether it should be capitalized or charged to expense of the current year and give your reason for the treatment you suggest.

7 *a* In the preparation of a balance sheet from the books of account of a manufacturing corporation, state under which section of the balance sheet *each* of the following items should be reflected; indicate also the specific wording of the title and caption used for each item:

(1) U. S. Treasury 2½% Bonds, due 1957

(2) 100 shares of U. S. Steel Corporation common stock carried at cost of $6,000 (quoted market value $6,500)

(3) U. S. Government ⅞% tax payment anticipation notes

(4) Reserve for wartime and postwar contingencies

b Write out the surplus section of a balance sheet to be published, properly classifying and describing the following items therein. The items are reflected in the surplus account on the books, as follows: $10,000 donated to the corporation by its stockholders in a prior year; $25,000 which arose during the current year as a result of the upward revaluation of the land and buildings; an operating deficit balance of $10,500 at the beginning of the current year; a net profit of $15,500 during this year; a credit of $285 representing an adjustment of the prior year's Federal income-tax liability.

8 *a* What are the reasons for and advantages of using controlling accounts?
b What is meant by the phrase "comparison of the details with the controlling account"?
c How often is the comparison referred to in *b* usually made in the ordinary business enterprise?

9 Would you defer the following items in preparing a balance sheet as at June 30, 1945, for a corporation on a calendar year basis? If so, explain for *each* item over what period of time you would charge it off; if not deferable, indicate why not.

a Unexpired fire-insurance premiums
b New York State Franchise Tax paid May 15, 1945
c Inventory of stationery
d The sum of $5,000 paid in June 1945, for magazine advertisements appearing in June and July issues
e Incorporation and organization expenses including lawyers' fees

10 On January 2, 1941, a corporation purchased factory land and buildings for $150,000, of which $50,000 represented the cost of land and $100,000 the cost of the buildings.

The buildings were depreciated at the rate of 5% per year, and at December 31, 1943, the reserve for depreciation aggregated $15,000.

On January 2, 1944, the Board of Directors had an independent appraisal made, which indicated a present, fair value of $60,000 for the land and $130,000 for the buildings.

The directors wish to adjust the books of account to reflect said fixed assets at the appraised values instead of at cost.

a In your opinion, is this upward adjustment proper? State your reasons for or against recording it on the books of account.
b If this upward appraisal is recorded on the books at January 2, 1944:
(1) What account should be credited?
(2) On what building valuation will depreciation for 1945 be computed?
(3) Will said depreciation be charged to profit and loss or to a surplus account?
c Assuming the fixed assets were recorded at their appraised value of $190,000 at January 2, 1944, and then at December 31, 1944, one half of said land and buildings are sold for $95,000, state what journal entries should be made to record the sale and the profit or loss thereon.

11 *a* Under what circumstances is it proper to capitalize factory overhead expense in the cost of machinery constructed by a concern for its own use?
b Define and explain "reserve for vacation pay" and state the reason for it.

c List *four* types of expenses or charges that should not be included in cost of production.

12 *a* What is a consolidated balance sheet?

b In what circumstances may a consolidated balance sheet and profit and loss statement be inadequate from the viewpoint of a stockholder or creditor?

c Does surplus of a subsidiary earned prior to acquisition form part of the consolidated earned surplus of the parent and subsidiary?

d A parent corporation carries its investment in its subsidiary at cost, and credits dividends received to current income. Is this treatment correct in the case of a dividend paid by the subsidiary out of its surplus earned prior to date of acquisition?

13 Explain and illustrate the installment basis of recording profits.

14 *a* Several years ago, Corporation A purchased 100 shares of the capital stock of Corporation B (representing a 5% interest) for $5,000. During the current year $2,000 is received by Corporation A as a partial liquidating dividend from Corporation B. What journal entry should be made on the books of Corporation A to reflect this dividend?

b Corporation C owns 100 shares of Corporation X capital stock, which it purchased for $11,000. The outstanding capital stock of Corporation X comprises 400 shares. Corporation X declares a dividend of one share of stock for each share held, and Corporation C, therefore, receives 100 shares of stock as its portion of said dividend; said 100 shares have a market value of $8,000, when received. What book entry shall Corporation C make upon receiving this dividend?

15 The partnership agreement between A, B and C (all the partners of The ABC Company) provides for 6% interest on each partner's capital balance at the beginning of the fiscal year and for a salary of $10,000 for A and $5,000 for B before the profits or losses are divided 33⅓% to each partner.

The opening capital balances are A—$20,000, B—$30,000 and C—$40,000; the net profit, before partners' salaries and interest are deducted, is $14,000. There were no drawings by partners during the year.

Submit journal entries to reflect the foregoing, including an entry recording the net profit or loss transferred to each partner's capital account.

PRACTICAL ACCOUNTING—Part II

Thursday, November 8, 1945—1.30 to 6 p. m., only

State your examination number on each sheet. Do not sign your name.

Consider carefully each requirement of each problem. Designate each solution by number. Consider technic and neatness as carefully as mathematics.

Answer the questions as directed under each group.

Group I

Answer one question from this group (25 credits). Indicate selection by a check mark (✓) placed at the left of the number on the question paper.

7 Prepare a Statement of Affairs and Deficiency Account for The M M

Corporation, which went into the hands of a receiver on September 8, 1944. The balance sheet of the company at that date was as follows:

ASSETS

Current assets			
Cash			$ 6,500
Accounts receivable		$40,000	
Notes receivable	$ 28,000		
Less: Notes receivable discounted	16,000		
		12,000	
		$ 52,000	
Less: Reserve for bad debts		9,000	
			43,000
Accrued interest receivable			900
Merchandise inventory			30,000
Unexpired insurance			1,200
Prepaid interest on notes payable			400
Total current assets			$ 82,000
Investments			
Capital stock of The B Company		$ 80,000	
U. S. Treasury Bonds		25,000	
Total investments			105,000
Fixed assets			
Land		$ 30,000	
Buildings	$150,000		
Less: Reserve for depreciation	25,000		
		125,000	
Furniture and fixtures	$ 15,000		
Less: Reserve for depreciation	5,000		
		10,000	
Total fixed assets			165,000
Deferred charge—Discount on bonds			1,000
TOTAL ASSETS			$353,000

LIABILITIES AND NET WORTH

Current liabilities		
Accounts payable		$ 85,000
Notes payable		35,000
Accrued salaries and wages		5,000
Accrued taxes		2,600
Total current liabilities		$127,600
Fixed liabilities—Bonds payable		100,000
TOTAL LIABILITIES		$227,600
Capital stock	$150,000	
Deficit	24,600	
		125,400
		$353,000

The land and buildings were mortgaged to secure the bonds payable. The estimated realizable value of the land is $20,000. The buildings are expected to produce $85,000.

The U. S. Treasury Bonds having an estimated realizable value of $26,000 at

September 8, 1944, were pledged with the First National Bank to secure the notes payable.

The B Company has gone into the hands of receivers, and creditors have been notified that they can expect to receive only 70% of their claims in final settlement. The stock of The B Company had been pledged by The M M Corporation as security for the accounts payable.

Accounts receivable are expected to produce the following amounts:

Good	$20,000
Doubtful (estimated to realize 60%)	15,000
Bad	5,000

Other assets are expected to be realized upon as follows:

Unexpired insurance	No value
Notes receivable	$12,000
Furniture and fixtures	6,000
Merchandise inventory	35,000

Of the notes receivable discounted, all of the notes are expected to be paid by the makers with one exception, a note to the amount of $1,500.

8 Prepare a consolidated balance sheet and consolidated operating statement from the following data:

Trial Balances, December 31, 1944

Debits	*M Company*	*P Company*
Cash	$ 100,000	$ 25,000
Accounts receivable	150,000	75,000
Plant (cost less depreciation)	350,000	200,000
Inventories:		
Raw materials	60,000	40,000
Work in process	75,000	50,000
Finished goods	45,000	30,000
Raw materials purchased	400,000	250,000
Manufacturing labor and expenses	300,000	200,000
Operating expenses	225,000	150,000
Dividends paid December 15, 1944	90,000	20,000
Investment in stock of P Company (cost)	275,000	....
	$2,070,000	$1,040,000
Credits		
Sales	$1,095,000	$ 750,000
Dividends received	18,000	....
Capital stock	900,000	200,000
Surplus January 1, 1944	57,000	90,000
	$2,070,000	$1,040,000

The M Company acquired 80% of the stock of P Company on January 1, 1944, and an additional 10% on July 1, 1944.

The inventories on December 31, 1944, were as follows:

	M Company	*P Company*
Raw materials	$50,000	$35,000
Work in process	65,000	25,000
Finished goods	35,000	10,000

The M Company bought raw materials during the last six months from P Company for $300,000. This represented the latter company's regular sales price. [Assume a uniform rate of gross profit throughout the year.]

The M Company had in its final inventory of raw materials $15,000 worth of material purchased from P Company, priced at P Company's regular sales price.

Group II

Answer one question from this group (25 credits). Indicate selection by a check mark (√) placed at the left of the number on the question paper.

9 Prepare a balance sheet and schedule of cash distributions.

A partnership comprised of A, B and C has decided to liquidate its business because of declining profits. The partners ask you to prepare a balance sheet of the partnership at December 31, 1944, and to devise a schedule showing the proper distribution of the available cash. The following facts are submitted:

The partnership agreement calls for the distribution of profits as follows:

A	20%
B	40%
C	40%

A, as manager, is entitled to an annual salary of $10,000, plus 20% of the profits before interest allowances but after the salary deduction. The bonus has not yet been entered on the books. Interest at the rate of 6% per annum is to be allowed on average invested capital during the year 1944, without regard, however, to the current year's profits or losses. None of the partners has private resources that may be drawn on in the event of a deficiency.

A trial balance of the company's books at December 31, 1944, follows:

	Debit	*Credit*
Cash	$ 325,000	....
Accounts receivable (considered collectible)	175,000	....
Inventory—December 31, 1944	55,000	....
Land and building (less reserve)	425,000	....
Machinery and equipment (less reserve)	150,000	....
Accounts payable	....	$ 30,000
6% Mortgage on land and building, maturing August 1, 1945 (interest paid to January 1, 1945)	....	100,000
A—Salary account	....	5,000
B—Loan (interest paid in full to January 1, 1945)	....	20,000
B—Withdrawals	10,000	....
C—Withdrawals	35,000	....
A—Capital	....	270,000
B—Capital	....	375,000
C—Capital	....	325,000
Sales	....	1,500,000
Cost of sales	1,250,000	....
Partner's salary	10,000	....
Other expenses	190,000	....
	$2,625,000	$2,625,000

The partners accepted the plan of distribution presented by you and, on January 10, 1945, made the distribution called for by your statement. A was appointed to take charge of liquidating the business at an annual salary of $6,000. You are requested to make up distribution statements for each three months until the business is liquidated, so that the receipts may be disbursed promptly.

The liquidation of the business by A resulted in the following cash collections for two 3-month periods:

On Accounts receivable:	
January 1—March 31	$50,000
April 1—June 30	50,000
Machinery and equipment sold, at book value:	
January 1—March 31	$35,000
April 1—June 30	25,000

On March 1, 1945, B offers to purchase the land and building at a valuation of $350,000 and to assume the mortgage and the interest payments thereon. A and C immediately accept the offer. Because of the probability of a deficit in B's remainder interest, B on the same date gave to the partnership a $30,000 second mortgage on the land and building in complete and final settlement of his account.

On March 20, 1945, as a separate transaction, A agreed with C to accept the junior mortgage as a distribution to his account at a discount of 20%.

The entire inventory was sold for cash on March 25, 1945, at book value.

From the above information, prepare the statements asked for by the partners, giving effect to the above transactions and to the quarterly distributions. The final distribution was made on June 30, 1945, the assets remaining unliquidated at that time having no value.

10 Prepare a balance sheet and operating statement from the following data:

A B C MANUFACTURING COMPANY

Trial Balance, December 31, 1944

	Debit	*Credits*
Cash	$ 50,000	......
Accounts receivable	150,000	......
Reserve for discounts	......	$ 9,000
Inventory of raw material, January 1, 1944	100,000	......
Inventory of work in process, January 1, 1944	9,800	......
Inventory of finished product, January 1, 1944	22,000	......
Machinery and fixtures	60,000	......
Reserve for depreciation	......	15,000
Prepaid expenses	2,000	......
Accounts payable	......	30,000
Capital stock	......	200,000
Undivided profits	......	176,200
Sales	......	552,000
Discounts and allowances on sales	35,000	......
Purchases—Raw material	194,400	......
Labor	113,950	......
Manufacturing expenses	149,900	......
Depreciation	3,000	......
Selling expenses	48,750	......
General expenses	43,400	......
	$982,200	$982,200

The company manufactures a specialty product from a variety of raw materials. Three different kinds—A, B and C—are produced, and based on previous experience, the cost is estimated to be:

	A	*B*	*C*	*Average*
Material	$10.00	$ 8.00	$ 6.00	$ 8.00
Labor	6.00	6.00	6.00	6.00
Overhead	6.00	6.00	6.00	6.00
	$22.00	$20.00	$18.00	$20.00

The company used the average cost of $20 in valuing the opening inventory and fixed the sales price for the year at $30 per unit. No record is available of the quantities put in process or produced of each product, but the $552,000 sales were found to be made up as follows:

Grade A	10,400 units	
Grade B	3,900 units	
Grade C	4,100 units	
	18,400 units	at $30 = $552,000

The opening inventory of work in process was comprised of: 700 units (200 of A, 300 of B and 200 of C), with material cost $5,600, labor cost $2,100 and overhead expenses $2,100—total $9,800.

The opening inventory of finished goods consisted of 1,100 units (300 of A, 500 of B and 300 of C) at the average cost of $20 each, or $22,000.

The inventory of work in process at the end of the year is 1,000 units (600 of A, 300 of B and 100 of C). Each is completed to the extent of one half, as to labor and overhead expense, but contains all of the material cost.

The inventory of the finished product at the end of the year is 1,700 units (200 of A, 500 of B and 1,000 of C).

The inventory of raw material at the end of the year is $80,000.

100TH ACCOUNTANT EXAMINATION

COMMERCIAL LAW

Friday, November 9, 1945—9 a. m. to 12.30 p. m., only

READ THESE INSTRUCTIONS BEFORE WRITING YOUR ANSWERS.

State your examination number on each sheet. Do not sign your name. Designate each answer by its number, in margin at left of ruling. Do not rewrite the question either wholly or partly in your answer. Consider each part of each question before you write your answer. Write legibly. State answers clearly, completely and concisely. File sheets of your answers in the serial order of the questions.

Answer the questions as directed under each group. Papers entitled to 75 or more credits will be accepted.

Group I

Answer all questions in this group.

1 *a* (1) What essential information would an accountant expect to find in a certificate of incorporation?

(2) Name *five* items that are of particular importance when making an audit.

b Define and differentiate the capital and capital stock of a corporation.

c What is your opinion of the action taken by the board of directors of a corporation as to (1) dissolution, (2) amendment of the charter, (3) increase or decrease of capital stock, (4) consolidation with other corporations, (5) sale of all of the corporation's assets? Explain.

2 *a* Adams delivered goods to a warehouseman and received a negotiable warehouse receipt for the goods. Yates recovered a judgment against

Adams and sought to levy on Adams' goods in possession of the warehouseman. Can Yates levy on or seize the goods? Can the warehouseman be compelled to deliver the goods to Yates? Explain.

b Bowen had two trucks, No. 1 and No. 2, which he delivered to repairman Young to have certain repairs made. Young, after making repairs to truck No. 1, delivered it to the owner, Bowen, without payment for the repairs. Young then refused to return the other truck, No. 2, until the repairs to truck No. 1 were paid for. Give your explanation of the position of both Bowen and Young in this circumstance, at common law.

c Farmer Andrews delivered to Bates one thousand bushels of apples; Bates agreed to "return to Andrews one gallon of cider for each bushel of apples." Was this a bailment or a sale and why?

3 *a* Allen, without receiving any consideration, and for the accommodation of Brown, signed a promissory note payable to Brown, who endorsed it, for value, to Cox. When Cox took the note, he knew that Allen received no value and was only an accommodation party. Brown is irresponsible and Cox sues Allen on the instrument. Can Cox recover from Allen? If not, why? If so, why?

b Amos, who was 17 years old, gave a note in payment for goods to Blue, who endorsed it to Coty, for value, before maturity. The note is not paid at maturity. Coty sues Amos and Blue. Both Amos and Blue set up the infancy of Amos as a defense. Can Coty recover from Amos; or Blue; or both; or neither? Explain.

4 *a* Alex agreed with Bowers to relinquish a part of a debt due Alex from Bowers if Bowers would pay the balance. This was reduced to writing and signed by both. Is this a valid contract? Explain.

b Aaron writes Bateman, offering certain merchandise at $500. Bateman sends a letter of acceptance by return mail on the day he receives Aaron's letter. When does a contract arise? Explain.

c Ace contracts for the sale of 5,000 tons of steel rails, agreeing to ship 1,000 tons per month. He ships 400 tons the first month. Must the buyer go on with this contract? Give your reasons.

d A memorandum of sale, naming the buyer and seller, under the statute of frauds, was signed by the buyer but not by the seller. Can the seller hold the buyer liable in an action on the contract of sale?

5 *a* A person gratuitously undertakes to do an act for another.

(1) What is his liability if he omits to do it and loss thereby occurs?

(2) What is his liability if he attempts to do it and does it so negligently that loss occurs?

b Ajax, conducting a business under his own name, made his promissory note to Brown's order for a purchase of goods. Later Brown discovered that Ajax was in fact conducting the business as agent for Coates. The note was not paid at maturity. What are Brown's rights? Discuss fully.

c An agent was instructed by his principal to purchase certain bonds at a certain price on a certain date. The agent was informed, from sources he believed to be reliable, that the next week the bonds would be lower in price. He waited, but the bonds increased in price above what they were on the day the agent should have bought them. Is the agent personally liable for the extra cost? Explain.

Group II

Answer five questions from this group. Indicate the questions answered by a check mark (√) placed at the left of number on question paper.

6 *a* In the absence of directions in the trust instrument, what are the duties of a trustee as to

(1) Income received from bonds purchased at a premium?

(2) Income from a wasting asset, such as royalties from a patent?

b What are the responsibilities of a trustee as to payments chargeable to (1) principal, (2) income?

c which of the following charges are chargeable to principal and which are chargeable to income of a trust?

(1) Cost of litigation to construe the meaning of trust provisions

(2) Cost of creating or continuing the trust

(3) Premium on trustee's bond

(4) Cost of finding trust assets

(5) Insurance

(6) Interest on mortgage

7 *a* Define bill of lading.

b What is (1) a straight bill of lading. (2) an order bill of lading?

c What *four* purposes are served by shipping goods under order bills of lading? Explain.

d Anson met Box and said to him, "For what will you sell me 500 barrels of flour?" Box replied, "Ten dollars a barrel, cash on delivery." Anson said, "All right, I accept; deliver the flour to my warehouse tomorrow morning." Flour immediately dropped in value and was worth $8 a barrel when Box tendered the flour to Anson the next morning. Anson refused to accept at the price agreed upon. What can Box do?

8 *a* Abel, of the firm of Abel, Brewer and Colt, makes a contract with Dane for partnership purposes. Abel is guilty of fraud in the making of the contract. Brewer and Colt are entirely ignorant of the matter. Dane sues Abel, Brewer and Colt. Is the firm liable? Explain.

b Arrow was admitted into the firm of Byrns and Company on January 1, 1944. At that time the firm was indebted to several creditors, including Conick. The firm thereafter became insolvent, and, the assets of the partnership and the other partners being insufficient to pay the partnership debts, Conick sought to hold Arrow personally liable for the deficit in his claim. Could Conick do so? Why?

c By written agreement between the copartnership, Yates and Zachary, and Daniels, their employe, Daniels is to receive for his services to Yates and Zachary a certain percentage of the profits of the business. Does Daniels thereby become a partner (1) as to Yates and Zachary, or (2) as to third persons? Explain.

d Which, if any, of the following acts may be performed by a partner of any number of partners (less than all in a going partnership business) without the consent or authority of all the partners?

(1) Assigning the property of the partnership for the benefit of creditors

(2) Disposing of the good will of the partnership

(3) Doing any act which would make it impossible to carry on the ordinary business of the partnership

(4) Confessing a judgement

(5) Submitting a partnership claim or liability to arbitration or reference

9 *a* What is the liability of a common carrier of (1) merchandise, (2) passengers?

b A railroad company transported goods to their destination and notified the consignee that the goods were ready for delivery. The consignee did not call for the goods until a week later. The day before he called for the goods they were destroyed by fire without the negligence of the company. Is the railroad company liable for the loss of the goods? If so, why? If not, why not? Explain.

c A station agent of the X. R. R. Company, through error, quoted a lower freight rate to a shipper than the real rate. A contract was made to ship and transport goods at the quoted rate. When the error is discovered by the railroad company, can the contract be rescinded by the carrier? Why? What principal is involved in this question?

d A shipper delivered goods to a railroad company for shipment. The train was derailed by train wreckers and the goods stolen. Can the shipper recover the value of the goods from the railroad company? If so, why? If not, why not? Explain.

10 *a* Allen and Bell are cosureties on a debt of Covey to Dixon for $12,000. Covey fails to pay. Allen is compelled to pay Dixon $8,000 in partial payment of the debt. Allen sues Bell, his cosurety, for $4,000 contribution. Can Allen recover $4,000 from Bell? State the reason for your answer.

b Define and distinguish between a suretyship, a guaranty, and an indemnity.

11 *a* During 1942, Jone Roe received a salary of $3,500 from employer Austin and a salary of $2,500 from employer Byrd. Assuming that each employer was subject to the social-security taxes on his employment, what federal social-security taxes had to be paid for 1942 on John Roe's salary by (1) the employers, (2) the employee?

b Is the federal old-age and survivor-benefit tax paid by the employer and employee during 1942 deductible from gross income for federal income-tax purposes?

c (1) What *three* essentials are necessary for an employee to become eligible for old-age benefits under the federal social-security laws?

(2) Is actual and complete retirement necessary ot obtain old-age benefits? Explain.

12 An accountant, in making a cash audit of the John Jones Company, finds in the cash drawer the three papers quoted or described below. Give your opinion as to the classification, the negotiability, and the valuation of each.

a "First National Bank

New York, N. Y.—May 1, 1944

This is to certify that John Doe has deposited with this bank one thousand dollars ($1,000) payable six months from date, with interest at four

per cent per annum upon return of this certificate properly endorsed.
B —— Cashier"

b "May 1, 1944
Due John Jones Company one thousand dollars
T. A. Smith"

c A note payable to John Jones Company from a customer in England payable in New York in English pounds, shillings, pence.

100TH ACCOUNTANT EXAMINATION

THEORY OF AUDITING

Friday, November 9, 1945—1.30 to 5 p. m., only

Read and consider carefully each question before answering. Write your answer clearly and concisely, being particular to express your own knowledge, for on that is based the rating. Avoid quotations from authors. Designate each answer by number and check (√) the number on the question paper, but do not rewrite the question as part of your answer.

Credit will be allowed not only for accuracy of answer but also for technic.

Do not sign your name to the paper. State your examination number.

Answer the questions as directed under each group. Papers entitled to 75 or more credits will be accepted.

Group I

Answer all questions in this group.

1 Tabulate all the audit points relating to the verification of the surplus and the capital stock, that are necessary for the certification of a balance sheet of a medium-sized corporation having a substantial number of stockholders, when the corporation acts as its own transfer agent, etc.,

a In the first audit made of the corporation that has been in existence over 20 years

b In a later audit engagement for the same corporation after a lapse of 5 years

2 Would you differentiate a balance sheet from a statement of assets and liabilities? Would there be any difference in your auditing procedures and the certifications you would issue for these two types of statements? Explain your answers fully.

3 When engaged to audit Corporation A for credit purposes, you find another corporation affiliated with them. Substantial advances have been made to the affiliate by Corporation A. The accounting department of Corporation A also keeps the books of the affiliate, and the officers of Corporation A are also the officers of the affiliate. No arrangements have been made to audit the affiliate for whom Corporation A manufactures certain products. Under these circumstances, what is the minimum attention it is necessary to devote to the affairs of the affiliate and to its relations with Corporation A? Explain fully.

4 Does the auditing procedure in a cash audit differ from the verification of the cash account in the course of an audit undertaken for the certification of a balance sheet for credit purposes? Explain your answer fully.

5 Outline your procedure in the verification of accounts receivable of a merchandising concern.

Group II

Answer five questions from this group. Indicate the questions answered by a check mark (√) placed at the left of number on question paper.

6 Under what conditions should an auditor recommend a detailed audit? In the course of such an audit, what three fundamental questions should be borne in mind?

7 In your audit of the accounts of a corporation you find that the Board of Directors authorized the payment of $100,000 to the trustees under a bond sinking-fund indenture. The trustees purchased 90 of the company's $1,000 bonds at 90, plus accrued interest on each bond of $5.

The bookkeeper charged the sinking-fund cash account with the amount authorized by the Board of Directors and credited the sinking-fund cash account with the cost of the bonds, plus accrued interest thereon. The surplus account was credited with the difference between the par value of the bonds and the amount paid therefor, plus accrued interest.

As the auditor, would you accept the entries as made? Explain your answer, giving reasons.

8 When making the first audit of a corporation, you find that it had been organized and had commenced business in 1940. The authorized capital stock was 10,000 shares of $100 par value each. One half of the authorized capital stock was issued to the incorporators for all their right and interest in certain patents, applications, etc. These patents covered a new article for which the market was unknown and speculative. By 1944, a wide market had been established on a very profitable earning basis, and it was determined that the patents had an earning power many times greater than the par value of the original stock issued therefor. Thereupon, the corporation issued the remaining half of its authorized capital stock to its stockholders in the same proportion as the issue of the first half.

As the auditor, do you approve of this procedure and, if so, what steps and entries would you advise the company to make? Give reasons.

9 Tabulate the important auditing procedures directly relating to the verification of the total inventories of a manufacturing plant and any correlated procedures involved in a detailed audit for an unqualified certification of the balance sheet.

10 As auditor in the balance-sheet presentation of Notes and Acceptances Payable, explain what differentiations are necessary, in general and in particular, in the case of an importer's direct liability under banker's acceptances.

11 Name the three usual methods of analysis an auditor uses to determine financial progress of a corporation. By using assumed figures, show how you would determine the "fund basis" of a machinery account when there have been purchases and sales of the asset between basic dates and the account has been subject to depreciation.

12 Outline briefly the system of internal check that you, as an auditor, consider adequate to control the commodity sales of a retail ice-delivery corporation operating two divisions with about 25 routes to a division and between 300 and 325 customers to a route. Trucks are loaded from an icehouse in each division. Customers' accounts are weekly, monthly or seasonal. A very few cash sales are made by drivers of the trucks.

PROFESSIONAL COMMENT

Mr. J. B. C. Woods, Chairman of the Society's Committee on State Taxation, has made the following statement:

Many of our clients have received credits under Section 577 of the New York Unemployment Insurance Law with result that they should be paying less than 2.7% on New York taxable payrolls of 1945. In order to protect this credit and to prevent it being automatically passed on to the Federal Government, care should be exercised in filing Treasury Department Form 940 for the calendar year 1945. In this connection a letter from a local Collector of Internal Revenue contains the following statement:

> "The Bureau has considered this problem and decided that, if the law of the State of New York is certified by the Social Security Board as provided in Section 1602 of the Federal Unemployment Tax Act, any contributions which a taxpayer is relieved from paying under the experience rating provisions of such law may be allowed as additional credit against the Federal tax as provided in Section 1601(b) of the Federal Unemployment Tax Act upon proper certification to the Bureau by the authorized officials of the State.
>
> "Form 940 has been printed for the calendar year 1945 and is substantially the same as the form used for the year 1944. Schedule B was not revised to provide for the special features involved in connection with the New York plan. However, it is not believed that any serious difficulty will be experienced by those employers who have been relieved from paying contributions by the State of New York. With regard to the best method of reporting such contributions, it is suggested that employers use Columns (1), (2), (7), and (8) of Schedule B. Column (8) will, of course, show the contributions actually paid in cash by the particular employer with respect to the calendar year. In Column (7) should be entered the the amount of contributions the employer has been relieved of paying during the calendar year 1945, that is, the amount of contributions used by reason of the credit granted by the State as distinguished from the amount actually paid in cash as reported in Column (8)."

Inquiry of the Social Security Board, as to whether the New York law has been certified, brought the following answer:

> "This is in reply to your letter dated November 16, 1945, in which you request information as to whether the Social Security Board has certified the New York State law, as amended, so that New York taxpayers may obtain additional credit against the Federal unemployment tax imposed by Section 1600 of the Internal Revenue Code.
>
> "Actual certification of State laws is not made by the Social Security Board until the 31st day of December in each year as provided in Section 1602(b) of the Internal Revenue Code. However, the New York agency has been advised that its law, as amended, is certifiable. There is nothing pending before this Board which will preclude certification of the State law on December 31, 1945."

It seems clear, therefore, that the New York law under which the credits were granted is in such terms as to insure the credit being retained by taxpayers, provided due care is taken in filing Form 940.

Social Security Tax Form Revised

The Society has been requested by the Social Security Board (Field Office, 11 West 42nd Street, New York City) to remind practitioners that "Employer's Application for Identification Number", Form SS-4, used for registering employers for purposes of filing Federal Social Security tax returns, was recently revised by the Treasury Department. "All Forms SS-4 dated prior to the revision of January 1945 are obsolete and should be destroyed," according to the Social Security Board, which further states:

"When an obsolete Form SS-4 is used, it necessitates correspondence with employers to obtain the additional information now required on the new form. This, in turn, may cause delay in the issuance of the indentification numbers and the receipt of the employer's quarterly tax blanks.

"Accountants who assist employers in completing Forms SS-4 should use only the January 1945 revision. In this way, you can avoid unnecessary inconvenience to your clients as well as to the Government. The new Forms SS-4 can be obtained from any Social Security Board field office or at any office of the Collector of Internal Revenue."

SECURITIES AND EXCHANGE COMMISSION

Accounting Series—Release No. 53
November 16, 1945
In Matter of "Charges in Lieu of Taxes"

* * * * *

Statement of the Commission's Opinion Regarding "Charges in Lieu of Income Taxes" and "Provisions for Income Taxes" in the Profit and Loss Statement.

The purpose of this statement is to outline the Commission's views in the matter of so-called "Charges in lieu of income taxes" and of "Provisions for income taxes" which are intentionally in excess of those actually expected to be payable; to give the reasons for that opinion; and to state its views on the points which certain accounting firms have made in connection with the principles discussed herein.

For some time there has been growing up a practice, tolerated by some accountants and sincerely advocated by others, pursuant to which the current income account is charged under the heading of income taxes or charges in lieu of income taxes, not only with the income taxes expected to be paid by the company but also with an additional sum equivalent to the reduction in taxes brought about by unusual circumstances in a particular year.[1] Certain public utility companies have included such charges and excessive income tax provisions among their Operating Expenses. This additional charge against income is, in most cases, offset either by a credit to surplus or by utilizing the reduction for some special purpose such as eliminating a portion of unamortized discount on bonds. The amount of the estimated reduction has been colloquially termed as "tax saving" and the general problem is loosely referred to as the "treatment of tax savings."[2]

This practice with its variants has caused the Commission some concern and it seems desirable now to state our views as to the accounting procedures appropriate in such situations and to give the reasons for them. In summary, our conclusions are as follows:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws.
2. It may be appropriate, and under some circumstances such as a cash refunding operation it is ordinarily necessary, to accelerate the amortization of deferred items by charges against income when such items have been treated as deductions for tax purposes.[3]

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[1] In general, the unusual circumstances are based on differences in the accounting treatment of certain items for income tax purposes and for general financial purposes. For example, losses and expenses which had to be taken as income tax deductions in a given period were not also taken as deductions in the profit and loss statement for the same period. Instead, because of differences in accounting methods, such items had already been charged off against income in previous years, or were being charged off directly to surplus or reserves, or were to be deferred and charged off against income in future years.

[2] We think this terminology is undesirable in principle and possibly misleading. Our preference is to call them "tax reductions." See note 23 *infra*.

3. The use of the caption "Charges or provisions in lieu of taxes" is not acceptable.
4. If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses being written off.
5. The location within the income statement of any such special charge should depend on the nature of the item being written off. In the case of a public utility, for example, a special amortization of bond discount and expense should not be shown as an operating expense but should be classified as a special item along with other interest and debt service charges in the "other deductions" section.
6. It is appropriate to call attention to the existence of the special charge by the use of appropriate explanatory language in connection with intermediate balances and totals.
7. In the preparation of statements reflecting estimates of future earnings, it is ordinarily permissible to reflect as income taxes the amount which it is expected will be payable if such earnings are realized provided, of course, the assumptions as to the tax rates are disclosed.
8. In the preparation of statements which are designed to "give effect" to specified transactions, the provision for taxes may, depending on all the facts and circumstances, properly represent either (a) the actual taxes paid during the period adjusted to give effect to the specified transactions, or, (b) an estimate of the taxes that it is expected will be payable should the income of future years be equal in amount to the adjusted income shown in the statement. The statement should, of course, clearly show what the provision for taxes purports to represent.

The reasons for our views can best be developed by using the facts relating to a registration statement recently filed by the Virginia Electric and Power Company (VEPCO) under the Securities Act of 1933 in which we took a position in the matter. This case is chosen not only because its facts are typical of most cases in which this problem arises but also because the public accountants who certified the financial statements in that case have since appeared before us and presented in detail their views in the matter.[4] The discussion of this case and of the general problem which it typifies will be presented under the following main headings:

I. *The background of the Vepco Case*—A brief description of the registration and of the transactions giving rise to the problem.

II. *The Certified Financial Statements Originally Filed*—A description of the certified financial statements originally filed, pointing out briefly our difficulties with the way in which the so-called "tax saving" was handled.

III. *Amendments to the Certified Statements*—A description of the certified income statements after each of the amendments, pointing out briefly in each case our objections to the treatment accorded tax provisions and "tax savings."

IV. *The Pro Forma Income Statements*—A brief description of the pro forma statements filed, pointing out our objections to the treatment of taxes in the statements originally filed.

V. *The Findings and Opinion of the Commission in the Related Case—In the Matter of Virginia Electric and Power Company (H.C.A. Release 5741)*—A

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[3] Under the controlling decisions of the Federal courts (*Helvering v. California Oregon Power Co.* 75 F. (2d) 644 (1935) D. of C. *Helvering v. Union Public Service Co.* 75 F (2d) 723 (1935) (Eighth Circuit) unamortized bond discount and expense applicable to bonds being refunded through the issuance of new bonds for cash are deductible for purposes of the Federal income tax in the year in which the refunding takes place. Not all accountants, however, are in accord that such items must as a matter of sound accounting be immediately written off. Many believe that such items should preferably be amortized against income over the life of the refunding issue if a correct statement of the cost of money is to be obtained. (C. F. Healy *Treatment of Debt, Discount and Premiums Upon Refunding*, 73 Journal of Accountancy, 199 (March 1942).

[4] In the summer of 1944, we caused to be circulated for comment a proposed Accounting Series release containing a tentative statement of our conclusions in this matter. Comments were received from accountants, registrants and others interested in the problem and a number of informal conferences were arranged with the staff and the Commission. Of the twenty-eight letters and comments received, five individuals or firms and a committee of the American Institute of Accountants objected to the general position taken in the draft. Subsequently, in December, 1944, the Committee on Accounting Procedure of the American Institute of Accountants issued a bulletin "Accounting for Income Taxes" which in a number of important respects is inconsistent with the conclusions we have reached. In January, 1945, the Committee on Accounting Principles and Practice of the New Jersey Society of Certified Public Accountants issued a statement with respect to the A.I.A. bulletin, taking some exception to the proposals made as to the treatment of "tax savings." In coming to a final conclusion in this matter, we have given extensive consideration to the views expressed and the points made by those commenting on the tentative statement of our views, as well as to the contrary position taken in the bulletin mentioned.

description of the financial statements and ratios set forth in that opinion which were criticized in some respects by the certifying accountants in their discussion of this problem.

VI. *The treatment of "Tax Savings" in Financial Statements Filed with This Commission*—A detailed discussion of the considerations underlying our views as to the treatment of income taxes and of so-called "tax savings."

I.

The Background of the Vepco Case

On March 23, 1945 the Virginia Electric and Power Company (VEPCO) filed with this Commission under the Securities Act of 1933 a registration statement covering its First and Refunding Mortgage Bonds, Series E. The statement after being amended several times became effective on April 20, 1945 as to $59,000,000 of such bonds. Certain financial statements of VEPCO included in the registration statement were certified by Lybrand, Ross Brothers & Montgomery. Those of Virginia Public Service Company, a company recently merged with VEPCO, were certified by Arthur Andersen & Co. Several days after the amended statement became effective, representatives of both firms of certifying accountants appeared before the Commission to discuss certain accounting questions as to the treatment of income taxes and of the so-called "tax-savings."

In the registration statement filed by VEPCO, certified financial statements for the years 1942, 1943, and 1944 were filed for VEPCO, for Virginia Public Service Company which had been merged with VEPCO on May 26, 1944, and for the two companies combined. In addition, there were filed "adjusted" balance sheets and income statements designed to give effect to the merger with Virginia Public Service Company, the sale of certain transportation properties, the proposed refinancing and certain related adjustments.

The accounting and "tax savings" issues[*] centered on the treatment to be accorded the following three items which arose out of transactions that had occured in 1944:

1. Premiums and expenses incurred in refunding VEPCO's bonds, amounting to $2,383,096.46.[5]
2. A loss of $3,418,715.16 sustained upon the sale by VEPCO of certain transportation properties.
3. An item of $600,949 said to arise out of the asserted fact that the normal depreciation on certain plant facilities was substantially less than the amortization of such facilities taken for tax purposes at 20% per annum under Section 124 of the Internal Revenue Code.[6]

In the original registration statement, and in all of the amendments, the registrant and its accountants took the position that the income statements should be prepared in such a way as to reflect therein charges equal to what it was estimated Federal excess profits taxes would have been had not the special transactions occurred. In the original filing the provision for excess profits taxes was shown as an operating expense not in the amount expected to be paid but in the amount that would have been payable had not the three special items existed. After the second amendment, the provision for excess profits taxes was shown at what was actually estimated to be payable for the current year under the applicable tax law, but a separate additional charge, specially described, was also included among the operating expenses in an amount equal to the difference between the provision for actual taxes and the estimated provision that would have been needed had not the three items existed. The third and fourth amendments altered the description of these special charges, and their position in the income account. The wording of some of the other related captions was also modified. As finally amended, special charges representing portions of the premium and expenses on redemption of the bonds and of loss on sale of properties were wholly excluded from the operating expenses and set out as a separate item of "deductions from income." The adjustment within the income account based on the treatment of emergency

[5] In 1942 Virginia Public Service Company called for redemption certain of its outstanding bonds. Unamortized debt discount and expense, call premium and expenses applicable to the redeemed bonds amounted to $2,021,708.13. Solely in order to simplify the present discussion, this item is not discussed in detail although its treatment involved much the same problems as the 1944 refunding.

[6] Section 124 of the Internal Revenue Code provides for the deduction by taxpayers, at their election, of accelerated amortization of property (including land) constituting an "emergency facility" by reason of certification by designated Government authorities that the property was necessary in the interest of national defense. Such amortization, which is in lieu of a deduction for ordinary depreciation usually at a much lower annual rate, is based on an arbitrary five-year life period but this may be amended to such shorter period as will end with the date officially declared as the end of the emergency war period. The President, by Proclamation, terminated the emergency period referred to in §124 as of September 29, 1945. The VEPCO statements do not indicate the dollar amounts of such facilities, the normal depreciation taken, or the amortization taken for tax purposes. The figure of $609,949 represents the company's estimate of the amount by which Federal taxes would have been increased had only the *normal* depreciation been taken for tax purposes.

facilities was eliminated. The extent to which this presentation reflects the views expressed in this opinion will be pointed out later.

In Exhibits A, B, C and D there are presented the relevant portions of the 1944 income statement as originally filed and after each amendment.

II.

The Certified Financial Statements Originally Filed

The Commission's directly applicable accounting requirements are found in Rules 3-01 (a), 3-06, 5-03 and 11-02 of Regulation S-X. The pertinent portions of the rules are reprinted in the margin:[7]

It is apparent that these rules called for the careful segregation and clear description of any conrecurring or unusual items charged or credited to the income account or to earned surplus. The plain import of caption 15 of Rule 5-03 is that there shall be shown thereunder only amounts actually provided for income taxes.

With those requirements in mind we turn to the income statement originally filed by the registrant, and certified by its accountants, purportedly in conformity to the requirements of the Securities Act and the rules and regulations issued thereunder.

As will be seen from Exhibit A, there was set forth in the 1944 income statement, as an operating expense, an amount for excess profits taxes equal to what the registrant computed would have been the amount of such taxes had none of the three special items existed. This excess profits tax figure appeared under the caption, "Taxes, excluding reductions shown separately below or applied against items charged directly to surplus."

The reduction in taxes attributed by the registrant to the excess of the tax amortization of emergency facilities over the normal depreciation thereon was added back to net income at the very bottom of the statement under this caption:

> "Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed through their normal life and not to replace existing facilities....$609,949."

The sum of this item and of a figure labelled "Net Income" was described as "Balance transferred to earned surplus . . ."

In the related surplus statements, charges were set forth in respect of the refunding costs and the loss on sale of transportation properties as follows:

> "Loss arising in connection with sale in 1944 of transportation property, less resulting reduction in Federal taxes on income ....$1,361,842.16"
>
> "Redemption premiums and expenses in connection with refunding of bonds, less resulting reduction in Federal taxes on income ....$291,919.46"

There were no notes to the certified income or surplus statements in further explanation of these items.[8]

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[7] a. Rule 5-03 (Profit and Loss or Income Statements) Caption 15—"*Provision for income and excess profits taxes.*—State separately (a) Federal normal income and excess profits taxes; (b) other Federal income taxes; and (c) other income taxes."

b. Rule 5-03, Caption 12—"*Miscellaneous income deductions.*—State separately, with explanations, any significant amounts, designating clearly the nature of the transactions out of which the items arose."

c. Rule 11-02 (Statement of Surplus) Captions 3 and 4—"3. *Other additions to surplus.*—Specify. If two or more of the classes of surplus specified in the rule as to the form and content of the particular balance sheet are stated in one amount, the nature of other additions to surplus (caption 3) and of other deductions from surplus (caption 4) shall nevertheless be so designated as to indicate clearly their classification in accordance with such applicable rule. 4. *Deductions from surplus other than dividends.*—Specify. See caption 3."

d. The second sentence of Caption 2B of Rule 5-03: "A public utility company using a uniform system of accounts or a form for annual report prescribed by Federal or State authorities, or a similar system or report, may follow the general segregation of operating expenses prescribed by such system or report."

e. Rule 3-01 (a)—"Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto."

f. Rule 3-06—"The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of statements required to be filed in the first instance with other governmental agencies."

[8] In the 1942 income statements of Virginia Public Service Company a similar transaction was explained by means of a footnote which if read in conjunction with the surplus statement disclosed the total refunding expenses. The note read as follows:

> "(C) Federal Income and Excess Profits Taxes:
>
> "Virginia Public Service Company and subsidiaries—The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting amortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring deductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of income for 1942 as special amortization of debt discount and expense. The bal-

The 1944 income statement as originally filed by the registrant and certified by its public accountants, did not comply with the applicable requirements and in our opinion was clearly misleading in the following important respects:

1. The total loss on sale of transportation properties was not shown.
2. The amount of refunding expenses in 1944 could not be determined.
3. The amount provided for the estimated tax liability for 1944 could not be determined.
4. The treatment and disclosure of similar transactions was different. In 1942 the amount of the estimated reduction in taxes due to the refunding was stated; this was not done as to the 1944 refunding. Also the treatment accorded tax deductible losses charged to surplus was different in 1942 than in 1944.

An investor could thus determine from the certified financial statements only that the *sum* of the tax liability *plus* loss on transportation properties *plus* the refunding expenses amounted to a certain figure as follows:

Provision for taxes (as shown in the income statement)	
Federal Income Tax....	$ 2,139,496.39
Federal Excess Profits..	8,164,870.79
Post-War Credit	(351,081.99)
Total tax provision	$ 9,953,285.19
Surplus charges, less resulting reduction in Federal taxes on income	
Loss on transportation properties	1,361,842.16
Refunding expenses......	291,919,46
	$11,607,046.81
Less:	
Reduction due to amortization of emergency facilities (as shown in the income statement).....	609,949.00
Balance	$10,997,097.81

It is true that by reference to the uncertified pro forma or adjusted income statements it can be determined that the reduction in taxes due to the items charged to surplus was $4,148,050. It is obviously unsound, however, to expect that a collateral disclosure in one set of statements will be inevitably and clearly connected by the reader with the information given in another and certified set of statements, at least without a clear cut cross reference.[9] This was apparently recognized since in the first amendment a paragraph was added to Note C to the income statement disclosing the $4,148,050 figure.[10] However, even with this figure before him the reader could determine only the aggregate reduction attributed to two wholly disparate items. It seems self-evident that the actual total loss on transportation properties sold and the total amount of refunding expenses are material facts. We think it equally apparent that the estimated amount of actual taxes is an important fact.[11]

There is another, though less patent difficulty. The amount shown for excess profits taxes was $8,164,870.79. The post-war credit

ance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942 was charged against earned surplus.

"However, the taxable net income as computed did not reflect the deduction, for tax purposes, of losses upon sales of ice and railway property, and certain other items charged to surplus. As a result, provisions charged to income in 1942 were approximately $330,000 in excess of the company's liability for Federal income taxes as shown in its tax return for that year. Pending review of the returns, this excess provision is included in accrued Federal income and excess profits taxes at December 31, 1943.

"In 1943 the company filed a claim for refund of 1941 Federal taxes in the net amount of approximately $297,000 under the carry-back provisions of the 1942 Revenue Act. However, this amount is subject to such adjustments as may result from review by the U. S. Treasury Department and the claim has not been recorded upon the books of the company." * * * (See also Exhibit A)

The total refunding expenses can be computed by adding the disclosed reduction of $1,571.158 to the $450,549.98 which is shown as a net direct debit to earned surplus.

[9] As we said in our opinion in the matter of *Universal Camera Corporation* (Securities Act Release 3076, June 29, 1945): "A disclosure which makes the facts available in such form that thier significance is apparent only upon searching analysis by experts does not meet the standards imposed by the Securities Act of 1933 as we understand that Act."

[10] The first amendment was filed before the staff issued its letter of deficiencies.

[11] The treatment in this case is particularly unsatisfactory since the aggregate "reduction" is not divided proportionately between the two items. From the amended statements, it appears that the *total* loss on transportation properties was $3,418,715.16 of which $1,361,842.16 or about *40%* appeared as a charge to surplus. In the case of the refunding expenses the total amount was $2,383,096.46 of which, however, only $291,919.46 or about 12% was charged to surplus. Inquiry developed that these differences were due first to the fact that in computing the estimated actual tax for the year, the amount recognized as an allowable tax deduction was about $1,000,000 less than the $3,418,715 recorded as a loss on the books; and, second, to the fact that the refunding expenses used as a tax deduction amounted to about $63,000 more than those written off in the accounts. The amount of the reduction in taxes due to each of these two items was computed by applying a rate of 85.5%, that is, the 95% excess profits tax rate less the 10% post-war credit. Without knowledge of these important facts, even an expert could do more than guess at what had been done with the accounts.

against excess profits taxes was shown as $351,081.99, or at the rate of about 4.3%. Since the post-war credit is normally 10% of the excess profits tax, the disparate relationship of these two figures should raise a question to even the average reader of the statement. There was, however, no explanation directed to this point. When the figure shown for excess profits taxes was reduced to the actual amount believed to be payable ($3,406,871.79) no change was made in the amount shown for the post-war credit. Apparently the amount by which the excess profits tax provision was increased on account of the charges to surplus was net of the statutory 10% credit. In other words, the figure shown as a provision for excess profits taxes was doubly a hybrid. First it combined actual taxes with "tax savings." Second to the extent of the estimated actual liability it was computed at the rate of 95%, but as to amounts in excess of actual liability, the rate used appears to have been 85.5%—that is, the full 95% less the 10% post-war credit.

There remains a final point—the caption under which the tax provision was set forth. The language "Taxes—excluding reductions shown separately below or applied against items charged directly to surplus" in our opinion scarcely lends itself to ready understanding but instead is apt very easily to convey exactly the opposite of its intended meaning through its use of "exclude me in" language. In our opinion such a description of this hybrid item represents a distinct barrier rather than an aid to understanding.[12]

In addition to all of the above difficulties, two much more basic questions are presented by the registrant's accounts: (1) whether there may or should be included in the operating expenses of a regulated public utility, under the caption of taxes, any amount in excess of the amount estimated to be actually payable under the applicable provisions of the tax laws; and (2) whether any amount should be included in or with such operating expenses to compensate for the reduction in taxes due to items like those in question here. These issues are raised more clearly by the statements in their amended form and discussion of them will be deferred until the amendments have been described.

III.

Amendments to the Certified Financial Statements

In view of objections on the part of the Commission's staff to the income statements as originally filed, a formal letter of deficiencies was sent on April 14, 1945 specifically criticising the presentation of the items under discussion as follows:

"Financial Statements

"Income Statements

"It is noted that the earned surplus statement for the year 1942 reflects charges aggregating $497,288.10 representing 'Unamortized debt discount and expense, call premiums and duplicate interest on long-term debt called for redemption, less resulting reduction in Federal taxes on income'. It is also noted that the earned surplus statement for the year 1944 reflects charges of $1,361,842.16 and $291,919.46 representing 'Loss arising in connection with sale in 1944 of transportation property' and 'Redemption premium and expenses in connection with refunding of bonds' respectively, less, in each instance, 'resulting reduction in Federal taxes on income'. Further, it is noted that the 1944 income statements reflect 'tax savings' aggregating $609,949.00 resulting from special amortization of emergency facilities.

"It appears that the total effective charges to savings in Federal income and excess profits taxes resulting from the above redemption of bonds, sale of property and special amortization of emergency facilities should be reflected separately in the income account under an appropriate descriptive title. In this connection, the title 'charge in lieu of taxes' will not meet such requirements. Such amounts should be shown immediately below the total of 'Operating Expenses and Taxes.'"[13]

Following the filing of the first amendment on April 2, there occurred several discussions with the staff based generally on the position taken in the letter of deficiencies dated April 14. In these discussions it was made clear that the staff took the position that the tax provision should not exceed the estimated amount believed to be payable and that charges to the income account "in lieu of taxes" could not be considered operating expenses. The staff also took the position that it would not object to charging the income account with so much of the two items charged to surplus (loss on sale of transportation properties and refunding expenses) as was equal to the company's estimate of the reduction in taxes caused by such items.

The second amendment was filed on April 16, 1945 substantially revising the certified in-

[12] See Note 9, *supra*.

[13] We do not construe this paragraph to mean that charges may be made to income for the so-called "tax savings," provided only they are separately set forth. If it does, we disagree. We construe the language to mean rather that where taxes are reduced due to special circumstances special charges of an equivalent amount may be made to the income account, if the particular item involved is one that may properly be made to income and if the special charge is clearly described for what it is, for example, "Special charge-off of unamortized bond discount."

come statement for 1944. In the amended statement, the provision for excess profits taxes was shown at the amount estimated to be actually payable. The following new item, equal to the reduction in the amount shown as excess profits taxes, was inserted under the general heading "Operating Expenses and Taxes".

> "Special charges equivalent to reduction in Federal excess profits taxes resulting from special amortization of emergency facilities (reduction shown separately below) and from redemption of bonds and sale of property (reductions applied against related items charges to surplus) . . . . . $4,757,999."

The item was inserted immediately after a total captioned "Total Operating expenses and taxes before special charges." The sum of the special charges and the above caption was labelled: "Total operating expenses and taxes including special charges" and this item was then deducted from the total of operating revenues to arrive at a figure labelled: "Net operating revenues." The remainder of the income statement, and the surplus accounts were the same as in the original filing except that a paragraph added by amendment No. 1 to Note C to the income statement was dropped, presumably because the $4,148,050 figure it disclosed could now be derived from data given in the income statement.[14] It will be recalled that this figure was the total amount by which taxes were estimated to have been reduced because of the loss on transportation properties and the refunding expenses.

The changes made are summarized in the following table:

	As originally filed	After 2d Amendment
Operating Revenues	$51,681,778	$51,681,778
Operating Expenses and Taxes:		
Other than Taxes	28,237,367	28,237,367
Taxes, excluding reductions shown separately below or applied against items charged directly to surplus[15]		
Taxes:		
Federal income	2,139,496	2,139,496
Federal excess profits	8,164,872	3,406,871
Post-war credit	(351,082)	(351,082)
Other	4,131,408	4,131,408
Total	42,322,060	—
Total operating expenses and taxes before special charges	—	37,564,061
Special charges, etc.	—	4,757,999
Total operating expenses and taxes, including special charges	—	42,322,060
Net Operating Revenues	$ 9,359,718	$ 9,359,718

The amended presentation was further questioned by the staff on these points:

1. The continued failure to disclose either the total loss on sale of transportation properties or the total refunding expense.
2. The impropriety of adding the special charges to operating expenses.
3. The propriety of the adjustment within the income account in respect of the amortization of emergency facilities.

The second of these points to some extent may conflict with the last sentence of the deficiency letter, quoted earlier, which read:

> "Such amounts (i.e., special charges) should be shown immediately below the total of 'Operating Expenses and Taxes.'"

Physically, of course, registrant's amended statement conforms to the deficiency letter by placing the special charges immediately after the total mentioned. It was the staff's position, however, that the deficiency called for their inclusion at that point as a separate, distinct and different item, rather than in such a way as to imply that the special charges were true operating expenses, though perhaps nonrecurring in nature. We feel that the language of the deficiency letter might well have been more explicit and so more in conformity with the oral statements made by staff members. In any event, however, the point is now moot since when the case was presented to us for directions, it was determined not to permit inclusion of such charges in or with operating expenses.

After some further discussion of the matter with the registrant and its accountants, the staff brought the case to the Commission for directions, presenting for consideration the

[14] See Exhibit B. The $4,148,050 figure can be derived as follows:

Special charges	$4,757,999
Reduction due to amortization of emergency facilities (shown as last item of income statement)	609,949
Remainder applicable to the two surplus items	$4,148,050

[15] This caption was deleted by the second amendment and the caption "Taxes" substituted therefor.

history of the case and the views of the registrant and its accountants both in this and other similar cases. We thereupon directed the staff to advise the registrant to the following effect:

1. That no adjustment should be made within the income statement based on the estimated reduction of income taxes due to the amortization of emergency facilities.[16]
2. That no objection would be raised to the inclusion in the income statement of an item of $4,148,050 representing so much of the refunding expenses[17] and of the loss on disposition of property as was equal to the estimated reduction in income taxes attributable thereto, the remainder of both these items being charged directly to surplus; provided, however, (a) that the caption for the item indicate clearly the nature and amount of the item being charged off and (b) that the special charge be excluded from operating expenses and shown as a deduction from gross income.

After being advised as to our views, the registrant on April 19, 1945 filed a third amendment. In the revised income statement, the $609,949 adjustment based on the amortization of emergency facilities was omitted and taxes were shown at the actual estimated amount thereof. The $4,148,050 of Special Charges was set forth as a separate item in the following manner:

Gross income (before special charges below)	$14,072,358.24
Special charges equivalent to reduction in Federal excess profits taxes resulting from redemption of bonds ($2,091,177) and sale of property ($2,056,873) (reductions applied against related items charged to surplus)	4,148,050.00
Gross income (after special charges)	$ 9,924,308.24
Deductions from income	3,719,526.80
Net income	$ 6,204,781.44

The qualification "before special charges below" was also added to two prior captions so that they read as follows:

"Total operating expenses and taxes (before special charges below)."

"Net operating revenues (before special charges below)."

In addition Note C to the tax item was amended to disclose that no adjustment had been made in the income statement on account of the difference betwewen depreciation taken therein on emergency facilities and the amount claimed therefor as amortization under Section 124 of the Revenue Code. The amount by which taxes were affected through this difference was given.

The staff brought the revised statements to our attention and we indicated that in our view the special charges should be classified as "other deductions" inasmuch as they represented items which, if charged to income, should, under the classifications of accounts to which the registrant was subject, be charged as an item of other deductions.

Upon being advised of these views the registrant filed its fourth amendment on April 20 in which the special charges were classified as an item of other deductions and Note C was expanded somewhat to set forth specifically the amounts charged to income in respect of the refunding expenses and the loss on transportation properties. As revised, the note no longer stated the amount of the tax reduction attributed by the registrant to the difference between the amount of depreciation and amortization taken on the emergency facilities. However, this amount can be derived from the other figures shown.

In transmitting to the registrant our views on the income statement as set forth in the third amendment, the staff indicated that the use of the words "before special charges below" in the several captions mentioned above was objectionable. We do not believe this position to be wholly sound. We feel that the existence of large special and unusual transactions ought properly to be forcefully brought to the attention of the reader of the statement. We feel also that the use of appropriate qualifying words such as "see special charges" in connection with the pertinent captions is an appropriate means of warning the reader of the existence of such items as were present in this case.

IV.

The Pro Forma Income Statements

In addition to the certified income statements for the years 1942-44, the registrant filed uncertified pro forma income statements under the following general title:

"Virginia Electric and Power Company
Pro Forma Income Statement for 12 months ended December 31, 1944, Giving estimated effect as at January 1, 1944 to Merger, Sale of Transportation Properties and Proposed Refinancing."

The actual 1944 income statements of VEPCO, and of Virginia Public Service prior to its merger with VEPCO on May

[16] Our views as to this particular variant of the general problem are outlined in note 35, *infra*.

[17] According to the registration statement these costs consisted of redemption premiums and expenses in connection with the refunding of the bonds.

26, 1944, wewre shown in two separate columns. In five additional columns there were shown (1) adjustments to give effect to the merger, (2) adjustments reflecting the sale of transportation properties, (3) adjusted statements prior to the proposed refinancing, (4) the refinancing adjustments, and (5) adjusted statements after the refinancing. We are here concerned primarily with the treatment accorded the tax items although some reference to other adjustments may be necessary.

In general, the presentation followed quite closely that used in the certified statements. As originally filed the total of income tax items shown in the two "actual" columns was the same as that shown in the certified statements, $9,953,285. This figure and the adjusted figure were both described as "Taxes —Federal income and excess profits (excluding reductions (1) as shown separately below and (2) of $4,148,050 related to and applied against items charged directly to surplus.") As pointed out earlier, these uncertified statements disclosed that which the original certified statements did not—the aggregate tax reduction resulting from the two items charged to surplus. In the statements filed adjustments of the "actual" tax figure were as follows:[18]

Tax provision as shown in the certified statements	$ 9,953,285
Add:	
Increase due to 1944 merger and refinancing	362,473
Increase due to redemption of Series B, C and D bonds and issuance of Series E bonds	294,552
	$10,610,310
Less:	
Reduction resulting from sale of transportation properties	2,793,565
Adjusted or "pro forma" tax provision	$ 7,816,745

A note keyed to the adjusted tax figure read:

"The amount shown above for Federal income taxes includes provision for estimated excess profits taxes of $5,661,205 before reductions (1) as shown separately in the income statement and (2) of $4,148,050 related to and applied against items charged directly to surplus, and after deducting estimated post war credit of $328,900."

Finally, the $609,949 adjustment relating to the emergency facilities was added back at the foot of the income statement just as was done in the certified statements.

The form of this pro forma statement of income was not criticized in the letter of deficiencies dated April 14 and no change was made by the second amendment. However, when the case was brought to us for directions, as noted above, we indicated that the same treatment should be accorded the pro forma statements as in the case of the certified statements.

In the third amendment, therefore, the pro forma statement was revised by eliminating the adjustment related to the emergency facilities, by reducing the initial and adjusted tax figures to the estimated amount of actual liability therefor, and by segregating the "special charges" so as to show them, in conformity with the certified statements after the third amendment, as a deduction from "Gross income (before special charges below)." The balance was entitled "Gross income (after special charges)." Note C was also revised to read:

"The amount shown above for Federal taxes includes provision for estimated excess profits taxes (after deducting estimated post-war credit of $100,356) of $903,206 which is after reductions (1) of $609,949 resulting from amortization of emergency facilities and (2) of $4,148,050 related to and applied against items charged directly to surplus."

In the fourth amendment the form of the pro forma statement was again changed. A figure was now shown labelled "gross income" after which were shown three items; namely, the "special charges" of $4,148,050; interest and amortization, $2,409,075, and amortization of plant acquisition adjustments, $693,168. These were deducted as a group from the gross income figure to give a balance labelled "Net Income." Note C was amended to add the following, "but does not give effect to tax savings of $2,379,096 which are expected to result from the proposed refinancing."[19]

In our opinion, it would be most difficult to prescribe a rigid rule for the handling in "pro forma" statements of items such as are here in issue. The difficulty is due very largely to the variety of situations dealt with under the name of "pro forma" statements. For example, that term has been used to describe estimates of future earinings when cast in the form of an income statement. It is also used, as here, to describe a statement in which the actual operations of some

[18] The first amendment raised the amount of bonds being registered from $33,000,000 to $59,000,000. This change required alteration of the amounts of some of the adjustments. However, the form of presentation was not changed from the original filing.

[19] This change is not germane to the present discussion which relates to the costs of a previous refunding.

past period are altered or adjusted either to "give effect" retroactively to certain specific transactions which have since taken place, or to "give effect" to certain proposed transactions.[20] Where a pro forma statement reflects a straightforward estimate of future earnings, it would seem that the problem under discussion does not exist, since clearly any amount shown therein as taxes would be based on estimates of future tax rates and future taxable income. In such circumstances there would rarely, if ever, be any occasion for "charges in lieu of taxes" or "tax savings." Here the situation is different. The VEPCO "pro forma" statements are based on the actual statements for the year 1944. A limited number of adjustments to the actual figures are made to illustrate how certain specified events might reasonably be expected to have altered 1944 reports had such events occurred at the beginning of 1944. In this case these events are (1) the merger with Virginia Public Service on May 26, 1944 and the 1944 refinancing; (2) the sale of certain transportation properties during the year and (3) the proposed refinancing. On the other hand no retroactive adjustment was made as to a rate reduction which took effect on April 1, 1945. Such adjusted statements are, of course, useful to the extent they shed light on the future by illustrating the probable scope of the changes now being carried out. They are, accordingly, a hybrid form, being neither *statements of actual operations* nor thorough going *estimates of future earnings*. In the present case, the changes made are relatively few so that, on balance, the adjusted statements are much closer in nature to an actual statement than an estimate of earnings. For that reason, we feel that our views as to the certified statements are applicable to the adjusted statement under discussion. We point out again, however, that here as in the certified statements it is proper to add an appropriate qualifying phrase to such captions as "gross income."

V.

The Findings and Opinion of the Commission in the related case under the Public Utility Holding Company Act of 1935

In their appearance before us the certifying accountants criticized certain data as to VEPCO that was included in our opinion in this case under the Holding Company Act.[21] Under the caption "Earnings" we set forth the following:

"Attached hereto as Exhibit B is an income statement of VEPCO for the twelve months ended December 31, 1944 adjusted to reflect the merger of Virginia Public Service Company and the recent sale of transportation properties and pro forma to reflect the proposed refinancing.

"Gross income, interest and amortization, and pertinent ratios are as follows:

TABLE IV.

	Adjusted	Effect of Refinancing	Pro Forma
"Gross income before Federal taxes on income	$16,234,038	$ •	$16,234,038
Federal taxes on income[1]	2,764,194	294,552	3,058,746[a]
Gross income	$13,469,844	$ 294,552	$13,175,292
Interest and amortization	$ 2,740,710	$ 331,635	$ 2,409,075
Ratio of gross income before Federal taxes on income to interest and amortization	5.92		6.74
Ratio of gross income to interest and amortization[2]	4.91		5.47

The accountants pointed out that the ratios of gross income to interest and amortization were not at all representative of what might be expected for the future, since the provision for taxes was $4,148,050 less and gross income $4,148,050 more than they would have been had the refunding and sale of transportation properties not taken place. They further pointed out that under their proposal either to increase the amount shown for taxes by $4,148,050 or to deduct a special charge of that amount before arriving at gross income the resulting ratios would be 3.40 and 3.75 before and after adjustment for the proposed refinancing. These ratios they believed were far more reliable indications of what might be expected for the future.

The materials included in our opinion show on their face the basis on which the ratios in question were computed. They are, in our opinion, a correct reflection of what occurred in the period. On the other hand, we agree with the certifying accountants that the current period was unusual to the extent at least

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[20] Rule 170 of the General Rules and Regulations under the Securities Act of 1933 prohibits the use of pro forma statements which purport to give effect to the receipt and application of any part of the proceeds from the sale of securities for cash unless the sale of securities is underwritten and the underwriters are to be irrevocably bound, on or before the date of the public offering, to take the issue. *Cf.* Rule X-15C1-9 under the Securities Exchange Act of 1934.

[21] In the Matter of *Virginia Electric and Power Company*, H.C.A. Release No. 5741. (April 20, 1945).

of the three transactions under discussion.[22] For that reason neither the current period nor ratios based on current results are fairly indicative of future possibilities. However, as will be pointed out in more detail later, we do not think the method of handling such a situation should be to alter or obscure the actual results of operation. Instead, we feel such a situation calls for a clear explanation of the circumstances. In this case, we feel that our opinion should have more graphically explained the situation by giving an additional set of clearly described ratios derived from the adjusted gross income figure referred to by the certifying accountants.

VI.

The Treatment of "Tax Savings" in Financial Statements Filed With This Commission

Cases involving the treatment of so-called "tax savings"[23] in financial statements have arisen with increasing frequency in recent months. For that reason, as stated earlier, we feel it desirable to state our views as to the treatment to be accorded such items in statements filed with us and to point out the reasons which have led us to those conclusions.

It is first necessary to state briefly certain of our general views as to the functions of financial accounting and the purpose of the income statement. In our opinion financial accounting is essentially historical in nature—it consists of an accounting for costs that have actually been incurred by the business and for the revenues that have been actually derived from the business. From a balance sheet point of view, the question is what part of past expenditures may still be treated as valuable assets, of benefit to future operations, and what part of such expenditures must be considered as having been used up or expired. In order to prepare an income statement, it is necessary to decide what part of the costs that have been incurred should be treated as expenses, and what part of the revenues obtained may be treated as income. Technically this process is sometimes spoken of as matching costs against revenues, the difference being, of course, profit or loss. The principal statement reflecting this matching up process for a particular period is the income statement.

In order to arrive at a more precise matching of revenues and costs, accountancy has developed many procedures for handling particular transactions where the cost is incurred at one time and the benefit is received at another time, either earlier or later.

Much the same treatment is accorded cases in which a company receives revenue either before or after it delivers the goods or services contemplated. Ordinarily, such receipts will be treated as realized income, not necessarily in the year in which the cash is received, but rather in the year in which goods are delivered or in which the service is rendered or the costs of rendering that service are incurred.

It is also necessary as a part of this process of matching costs and revenues, for the purpose of determining income, to consider at appropriate intervals whether any amounts presently reflected as assets in the accounts should in the light of present conditions be written off or reserved against. Finally, consideration must be given to whether there exist contingencies for which provision should be presently made either by recognizing an actual, though perhaps estimated, liability, or by providing an appropriate reserve.

We have elaborated these underlying accounting assumptions in order to demonstrate further that financial accounting is in our opinion concerned with what did happen, not with what might have happened had conditions been different. And it does not attempt to forecast the future even though it supplies

[22] It should be noted, however, that three of the four years from 1942 through 1945 are "unusual" by this test. In 1942 there were "Special charges" of $1,571,158 in connection with a refunding in that year. In 1944 there were the $4,148,050 "Special charges" in issue here. In 1945, it is estimated there will be $2,379,096 "Special charges" due to the proposed refunding. Only on 1943 were there no "Special charges." For the four years average gross income was $10,808,313 and average "Special charges" were $2,024,576.

[23] We think it undesirable in principle and possibly misleading to refer to this problem as involving "tax savings" although due to the general use of the term in this sense we have adopted that nomenclature here. It seems to us that the term "tax saving" is apt to connote some sort of standard or normal tax law and a standard or normal earnings year to which that law applies. The facts are, of course, that there has not been a static or standard or "normal" tax law or tax status; nor has it been possible except in most unusual cases to characterize any particular fiscal year of a company as a "normal earnings" year, from which all others are to be regarded as a departures. Under such conditions, each year's tax is whatever happens to result from the application of the computation formula, provided by the tax law of that year, to the sum total of taxable transactions and tax deductions resulting from whatever business may have been done in that particular year. Moreover, the past few years during which the term and the problem of "tax savings" appeared have clearly been unusual in nearly every respect. Finally, if the phenomenon in question is to be described as a "tax saving" it would seem necessary to describe as a "tax loss" the failure to carry through a transaction which it can be said would have resulted in a "tax saving." And if taxes in one year are higher should not that increase itself be considered to be a "tax loss." Our strong preference is to describe the problem as involving "tax reductions."

much of the material used in making such a forecast.[24]

There is, on the other hand, another field of financial statistics in which statements are used which in form and language are closely similar to the financial statements used in presenting actual balance sheets and income statements. This is the field of financial analysis and forecasting. In essence, the analyst begins with reports of actual operations and conditions and adjusts them to give effect to expected future changes and events in order to arrive at his estimate of future earnings. In one form of analysis and forecasting the analyst is content to comment upon the actual past results, to point out what parts of the past results are due to factors which are not expected to continue and how the existence of new factors and conditions is expected to alter past results. At times, however, the analyst goes further and attempts to prepare an "adjusted" statement which purports to show how past operations would have worked out had certain specified subsequent events taken place earlier. Finally, the analyst may seek to forecast as accurately as may be what he expects will be the results of future operations. Frequently, in such cases, his forecast takes a form very like that used in portraying the results of past operations.

The validity of such analyses and forecasts, whether in the form of "comments," of "adjusted statements," or of "estimated future income statements," is clearly no greater than the soundness of the prophecies and estimates upon which they are based. The results shown, however, are meaningful to a reader only to the extent he is aware of and agrees with or understands the nature of assumptions and estimates made. In contrast to such forecasts, a statement of past operations, even though it is based in important part on opinion and judgment is primarily an historical record of actual events, not of prophesied future events.

The two types of financial statements are obviously in wholly different categories and have different uses in examining the investment merits of a security. Particularly because of the similarity in form, great care must be taken to ensure that the reader will be aware of the nature of the particular statement. Nothing, in our opinion, would be more misleading than to present, in the guise of an actual earnings statement, data which, in fact, was an estimate either of expected future earnings or of the effects of subsequent conditions and transactions on prior operations. The dangers inherent in the situation led us some years ago to adopt rules under the 1933 and 1934 Acts forbidding the use of "pro forma" statements unless a clear indication is given of the assumptions on which they are based.[25] Also under the 1933 Act we have by rule prohibited altogether the use of "pro forma" statements in certain cases. Apparently with a similar appreciation of the danger of confusing actual and pro forma income statements the American Institute of Accountants has for many years included in its Rules of Professional Conduct the following:

> "12. A member or an associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast."

Notwithstanding the uncertainty inherent in estimates of future earnings, it is apparent that the formation of a considered investment judgment ordinarily involves a conclusion as to the future prospects of the company. It is necessary in the administration of the Public Utility Holding Company Act in arriving at a decision as to the propriety of a particular security in relation to the capitalization and earnings, or as to the fairness of the price at which securities or assets are proposed to be sold. Under the Chandler Act it is a necessary step in arriving at a conclusion as to whether a proposed reorganization is fair and equitable and feasible.

In reaching a judgment as to the future prospects of a company it is customary to begin with a statement of actual operations for an appropriate past period. Because of this use of actual statements of operations, an effort is ordinarily made to present the results of prior years' operations in a form that is as readily usable as possible for that purpose. In general, what is done is to segregate and ear-mark what are considered to be unusual and non-recurring items of income, expense and loss so that the reader will be warned of them and so may arrive at a conclusion as to whether such items can be expected to recur. In addition, special treatment is accorded items of income or loss or expense that have been reported in the financial statements of one year, say 1943, but which by reason of later events or knowledge, are now known to have been actually part of the costs of revenues applicable to another year, say 1942. In such cases, it is customary

[24] Although we here emphasize the essentially historical character of financial accounting, it is by no means to be inferred that we feel the work done by the financial accountant is therefore mechanical or routine in nature. On the contrary, proper discharge of his duties and responsibilities presupposes that the financial accountant possesses and exercises an extremely high degree of professional skill, experience and judgment. We dicuss this point further at p. 25 *ff*.

[25] *Supra*, Note. 20.

in filing comparative statements for the two years to include such items in the year to which they are now known to be related. Such adjustments are in our opinion entirely proper and ordinarily desirable provided, of course, that appropriate disclosure is made so that the comparative statements can be reconciled with the 1942 and 1943 statements as originally issued. Finally, disclosure should be made as to significant, known factors that might render past earnings statements, or particular items therein, not indicative of probable future operations.[26] With such information at hand the reader of the statement is informed of what the past operations were, and of the conditions or transaction, which in the draftsman's judgment, are apt to be unusual and not apt to recur. In our opinion, this is the boundary line of financial accounting. It is the place at which the financial accountant in his capacity as such should stop. He is, we feel, essentially a historian, not a prophet.

This desire to prepare statements in a form more readily usable in estimating the future has led some to attempt to present what can be called a "normal" income statement, the inference being that the statement shows about what can be expected to happen year after year. The broad justification alleged for the practice is that if the actual results of the year's operations are unusual a reader may be misled into thinking the abnormalities will recur and that the best if not the only way to avoid such misconceptions is to "normalize" the statement—that is, to exclude therefrom the effects of some or all of the conditions which in the opinion of the draftsman are deemed to be unusual.

The dangers inherent in such a practice are numerous. In the first place the draftsman's judgment as to what is abnormal can scarcely be considered infallible. In the second place, there is certainly as much danger that the reader will fail to understand what has been done by the draftsman as that he will fail to recognize that the unadjusted statements are abnormal. Finally, the method is extremely susceptible of misuse through conscious or unconscious bias in making decisions as to what is unusual or abnormal about the current year. To a degree, of course, the care with which disclosure is made of the extent of normalization may serve to minimize the possibillity of misleading the reader. But in general we are satisfied that a statement purporting to reflect the actual results of operations is far less likely to be misleading if abnormalities are explained than if they are eliminated by adjustment in the statement even with an explanation of the elimination set forth in a note.[27] If, of course, a clear and full explanation of the adjustments made is not given, the practice is highly deceptive and may be fraudulent. It may be noted in passing that accountants have long condemned such undisclosed "adjustments" terming them at times a device akin to "equalizing earnings."

We conclude, then, that the proper function of an income statement presenting the results of operations is to present an accurate historical record. On this basis it is evident that the items included therein should clearly and accurately reflect only actual operations. It is accordingly our view that the amounts shown should be in accordance with the historical facts and should not be altered to reflect amounts that the draftsman considers to be more "normal" or likely to recur in future years.[28]

[26] In our opinion *In the Matter of The Colorado Milling & Elevator Company* (S. A. Release No. 2964, December 20, 1943) we had occasion to emphasize the need for disclosure of major changes in financial and operating factors that rendered statements of past earnings not fairly indicative of what might be expected for the future. In that case the registrant had disposed of a large investment portfolio the income from which had of course been included in past earnings statements, had used the proceeds of this sale and of a $2,000,000 bank loan to pay an extraordinary cash dividend of $7,000,000 and now proposed to issue some $3,000,000 of new 4% debentures. It had entered into new agreements for lines of bank credit at a much higher interest rate. Finally it had materially increased the rate of management compensation and had determined to extend its insurance coverage at a material increase in the amount of insurance premiums payable. In view of these significant changes in financial and operating factors and their material effect on the future earnings of the company, we said:

"The net effect of the foregoing will be to diminish the net income available for dividends. Profit and loss statements are required in the registration statement as an indication to prospective investors of the registrant's earning power. The nine-years' profit and loss statement contained in this registration statement reflected the results of operations during a period when the registrant had maintained continuously a financial status substantially equivalent to that existing immediately prior to this financing. By reason of the changes effected since May 22, that financial status bears little resemblance to that which obtains presently. Where such changes will have a material effect on prospective earnings, the omission to disclose those changes and their effect with relation to the profit and loss statements is as misleading as if the registrant's past earnings had been misrepresented."

[27] Where the tax provision is presented as in the original VEPCO statements or a charge in lieu of taxes shown, we doubt whether any but the most experienced reader of financial statements would be apt or perhaps able to make the calculations necessary to arrive at the amount of net earnings or of net earnings per share based on the actual tax payable.

[28] We do not at this time propose to discuss the practice of treating certain types of losses and income as corrections of surplus rather than as elements of profit and loss to be reflected in the year's income statement. That question is involved in certain proposed amendments to Rule 5-03 of Regulation S-X, which have been distributed for comment to interested persons. The comments received have not yet been fully analyzed, and it is likely that further steps will be taken to develop the nature of the problem and any conflict of opinion as to its proper solution. We feel it inappropriate in this statement to seek to anticipate the outcome of that investigation.

We return now to the particular problems presented by the facts in the VEPCO case. In their appearance before us the certifying accountants objected to our position and defended their proposal on three principal grounds:

(1) That as an accounting matter it is necessary to "allocate" the actual taxes as between charges to surplus and income from operations, even if that practice results in the inclusion in the income statement of a charge (described as taxes or as charges in lieu of taxes) in excess of the actual taxes payable, with an offsetting "credit" or "negative tax" being carried to surplus in amount sufficient to reduce the charge on account of taxes to the amount actually payable.

(2) That the adjustment of the tax figures, or the inclusion of a charge in lieu of taxes in or on a parity with operating expenses, results in the income statement being more useful to investors since it is more nearly indicative of "normal" conditions and probable results in the future.

(3) That in the setting of rates for regulated public utilities it is proper to base future rates on expected future taxes, hence the adjustment method tends to conform the income statement to the basis on which the rates of the company will be set.

For convenience, we shall first discuss the latter two points leaving the allocation argument until last. The second contention we believe to be unsound for the reasons stated in our general discussion of the functions of financial accounting and of income statements reflecting the results of past operations. We think such statements should be historical records of the results of whatever financial events actually took place. It is not the role of the financial accountant to adjust them so as to eliminate the effect of unusual circumstances which actually occurred. Accordingly, we can not agree with this contention. To include under operating expenses as taxes an amount which is not taxes because the substituted amount is considered by the draftsman to be "normal" is precisely the type of adjustment which we believe unsound in a statement of actual operations. And if the amount of the adjustment is undisclosed the statements are deceptive to a point that may border on fraud. If the fact of adjustment be disclosed but not the amount, the statements are still misleading in our opinion and, at the very best, are useless as reports of actual operations.

There is a related difficulty. If the "credit" to surplus or "negative tax" figure offsetting the enlarged charge to income is netted without disclosure against the loss or expense charged to surplus, the reader will be unable to determine the actual amount of the loss or expense in question. In our opinion such an event as the sale of corporate property at a substantial loss is an important fact. It is no less important because, fortuitously or intentionally, one of these events occurs in a year of high tax rates and high income, so as to effect a substantial reduction in the income taxes payable. There are in these cases *two* facts to be disclosed—the loss on the property, and its tax consequences. Such a transaction ought to be reported in such a manner as not to conceal either the fact that a loss was suffered or the amount of the loss. To report this kind of loss net of its tax consequences is no more supportable in our judgment than to report on a similar net basis an expense such as advertising, depreciation, interest or any other item in the income account.[29]

The third argument advanced in support of the enlarged charge to taxes, or of the charge in lieu of taxes, is that the income tax figure which is a significant factor in respect of the rates of a regulated public utility is not the actual amount of taxes paid but the amount that would have been payable but for the loss or expense carried to surplus. This argument is, of course, limited in its application to public utilities whose rates are subject to governmental regulation. Such companies are ordinarily required to follow a uniform system of accounts and, in most jurisdictions, the prescribed form of income statement shows income taxes as an element of operating expenses, or as is sometimes said "above the line." Generally speaking, items included "above the line" are recognized as expenses allowable in computing the gross income for rate purposes whereas deductions made "below the line," such as interest, and items carried to surplus are not chargeable in this way.[30]

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[29] It will be noted that an income statement which is charged only with the estimated amount of taxes actually payable thereby reflects the tax reduction due to special items. Moreover, the benefit of the tax reduction will be reflected in earned surplus, the amount of which will ultimately be the same whichever of the several suggested treatments of these tax reductions is followed.

[30] The deductibility of income taxes in computing return for rate purposes was an issue in *Galveston Electric Company* v. *Galveston*, 258 U. S. 388, 42 Sup. Ct. 361 (1922). There the Supreme Court, speaking through Mr. Justice Brandeis, said: "All taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between state and Federal taxes or between income taxes and others." This position was reaffirmed in *Georgia Railway & Power Co.* v. *Georgia Railroad Commission*, 262 U. S. 625, 43 Sup. Ct. 680 (1923). These decisions dealt only with the normal income tax then in effect. Therefore, because of certain observations by Justice Brandeis there

The short answer to this contention is that in most, if not all cases, the required systems of accounts do not permit a charge to operating expense accounts except for expenses actually incurred.[31] We note that the Committee on Statistics and Accounts of the National Association of Railroad and Utilities Commissioners has, in Case E-80, so interpreted the N.A.R.U.C. classification.[32]

We think, moreover, that this contention of the accountants in this case is unsound on its face. The costs and expenses, including interest, that arise from the borrowing of capital are almost universally excluded from the computation of gross income for rate making purposes. To include in operating expenses by indirection an item which is specifically excluded therefrom is obviously improper. Yet this is what is here proposed. The credits, in this case, that offset the charge in lieu of taxes have been deducted from the refunding expenses and the loss on sale of transportation properties, respectively, so that the charge to surplus is a net charge. To include in operating expenses part of the refunding expenses either directly or in the guise of a special charge in lieu of taxes is a violation of the premise that the costs of borrowing money are not a deduction in computing return for rate purposes. It would be as logical to say that the interest paid in a given period reduces the income tax payable and that therefore a charge in lieu of taxes should be included above the line with an offsetting reduction in interest expense below the line.

Finally, this contention seems to us to misconceive the relation of past results to the process of rate making. Where rates are being set for a future period, it is obvious that the actual results of past operations are only indications of what may be expected to be forth-coming in the future. The problem is, broadly, to determine what future earnings may be expected to result from particular rate structures. Consequently, it is customary

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are those who argue that these decisions may not be controlling as to the present Federal tax, particularly the present excess profits tax. Thus, in the *Galveston* case the court took care to point out that under the tax law then in effect the stockholder did not have to include dividends received from the corporation in his income subject to the normal Federal income tax and that this tax exemption was therefore, in effect, part of the return on his investment. Under the current tax law such dividends are taxable to the recipient. The court also said: "But the fact that it is the Federal corporate income tax for which deduction is made, must be taken into consideration in determining what rate of return shall be deemed fair."

The Supreme Court has not yet had before it a case involving the deductibility for rate purposes of an excess profits tax actually paid by the company. Some question as to its deductibility is, however, raised by the language used by Mr. Justice Douglas in his dissenting opinion in *Vinson* v. *Washington Gas & Light Co.*, 321 U. S. 414, 64 Sup. Ct. 731 (1944). He there said, in discussing a provision of the Stabilization Act of 1942 which prohibits any "utility" from making "any general increase in its rates or charges which were in effect on September 15, 1942" without giving the Director of Economic Stabilization the right to intervene in the proceedings:

> "I believe moreover, that when Congress halted general rate increases and gave the Director a right to intervene, it did not sanction rate increases regardless of need and regardless of inflationary effect. I think it meant to make utility commissions at least partial participants in the war against inflation and gave them a sector of the front to control. Though it did not remove the established standards for rate-making, I do not think it intended utility commissions to proceed in disregard of the requirements of emergency price control and unmindful of the dangers of general rate increases. To the contrary, I think Congress intended that there should be as great an accommodation as possible between the old standards and the new wartime necessities. The failure of the Commission to make that accommodation is best illustrated perhaps by its treatment of taxes. The Commission allowed the company to deduct as operating expenses all income taxes up to and including 31%. That this amount includes wartime taxes is evident from the fact that the highest corporate tax rate which prevailed from 1936 to 1939 was 19%. We all know that the extraordinary expenditures incurred for the defense of the nation started withe the Revenue Act of 1940. It has been accepted practice to deduct income taxes as well as other taxes from operating expenses in determining rates for public utilities. *Galveston Electric Co.* v. *Galveston*, 258 U. S. 388, 399. But this is war, not business-as-usual. When income taxes are passed on to consumers, the inflationary effect is obvious. And it is obvious. And it is self-evident that the ability to pass present wartime income taxes on to others is a remarkable privilege indeed."

In Detroit v. *Michigan Public Service Commission*, — *Mich.* — 14 N.W. (2d) 784 (1944), the Michigan Supreme Court held, with three Justices dissenting, that the *Galveston* case did not control the treatment in rate cases of the present Federal excess profits taxes. Writing for the majority, Justice Bushnell said, "As I read *Galveston Electric Co.* v. *Galveston*, 258 U. S. 388, 399, 66 L ed 678, PUR 1922 D 159, 42 S Ct. 351, which is intimated by my brother as controlling, its authority is limited to normal taxes and not to abnormal and avoidable taxes on 'excess profits' even though is must be conceded that the term by which such tax is designated is a misnomer. Excess profits are a question of fact for determination by the Commission."

A similar result was reached by the West Virginia Supreme Court in denying the deductibility of the excess profits taxes levied during the first World War. *Charleston* v. *Public Service Commission*, 95 W. Va. 91, 120 S. E. 398 (1923).

In its decision in *City of Detroit* v. *Panhandle Eastern Pipe Line Co.*, 3 F.P.C. 273 (1942), the Federal Power Commission, at p. 291, expressed its objection to the allowance of excess profits taxes in computing returns as follows:

> "Thus it appears that the doctrine of unjust enrichment as well as equity and good conscience compel the conclusion that a utility should not be permitted to thwart the purpose and spirit of the war price control legislation and the revenue laws by passing such abnormal tax requirements along to its consumers as an operating expense to be collected in increased rates. Indeed, we feel increased rates on such a basis would be unjustifiable. To allow them would in effect impose upon the consumers a sales tax.
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> "So that there may be no confusion concerning the tax situation in connection with the companies subject to our jurisdiction, where necessary to stabilize utility rates at reasonable levels during the

to "adjust" many of the past operating expenses to bring them into line with present or anticipated conditions. Among such conditions are, of course, future taxes and tax rates. Accordingly, in the approximations made of future expenses there would be included not the actual taxes of the past year, or even what the taxes would have been had there been no unusual transactions such as a bond refunding, but instead an amount equivalent to what the income tax will be in the future in view of the assumptions made as to future income and future tax rates.[33] The amount of past taxes would be used only if, after examination, it was concluded that tax rates and future income were not expected to change.[34]

The rate making process is thus not unlike the formulation by the investor of his judgment as to the future prospects of the company. In both cases, reports of actual past operations are used as a starting point. In both cases, these actual statements are analyzed to determine the extent to which they may be relied on as indicative of the future and, where necessary, appropriate adjustments are then made. Except that the possibility of misleading the reader is very largely absent when the user is a rate making body, the comments we have made earlier as to pro forma statements are applicable here—and with this addition that the judgment of the draftsman as to what is the normal or proper amount of taxes is less important, since for rate purposes the judgment of the rate making body on this point will generally be conclusive.

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war emergency period, we propose to allow as proper operating expenses only such taxes as may be termed ordinary or normal. For the purpose of distinguishing between ordinary or normal and war emergency or abnormal taxes, we conclude that the basis prescribed in the 1940 Revenue Act establishes the highest possible level of Federal taxes which may be allowed as an element of operating expense for such purpose. The 1941 Revenue Act and the pending 1942 proposal certainly reflect abnormal tax requirements for war purposes."

The Federal Communications Commission in *Re Investigation of Rates and Charges*, 50 PUR (NS) 468, 489 (1943) also disallowed a deduction for excess profits taxes. The trend of a number of state utility commission decisions seems to be to limit or deny the deductibility of excess profits taxes. See *In Re Los Angeles Gas & Electric Corporation*, P.U.R. 1922 A, 283 (California); *Re Western States Gas and Electric Co.*, P.U.R. 1919 B, 485, 493 (California); *Re Vallejo Electric Light & Power Co.*, 55 P.U.R. (N.S.) 435, 443, 454 (1944) (California); *Re United Fuel Gas Co.*, P.U.R. 1920 C, 583, 606 (W. Va.); *P.U.C.* v. *Springfield Gas & Elec. Co.*, 53 P.U.R. (N.S.) 95, 105 (1944) (Missouri); *Re Washington Gas Light Company*, 53 P.U.R. (N.S.) 321, 327, 336 (1943) (District of Columbia); *Re Northern States Power Co.*, 55 P.U.R. (N.S.) 257, 273 (1944) (North Dakota). cf. *Re British Columbia Electric Railway Company Ltd. et al.*, 53 P.U.R. (N.S.) 438, 464 (1943) (British Columbia). An excess profits tax which had been neither reported to the government nor paid was not allowed as a deduction in *P.S.C.* v. *Utah P. & L. Co.*, 50 P.U.R. (N.S.) 133, 167 (1943) (Utah). But see *Pfeifle* v. *Pennsylvania Power and Light Co.*, 57 P.U.R. (N.S.) 1, 32 (1945) (Pennsylvania); *San Antonio Pub. Service Co.* v. *San Antonio*, P.U.R. 1924 A, 259, 263 (Texas); *Detroit* v. *Detroit Edison Company*, 50 P.U.R. (N.S.) 1, 3 (1943) (Michigan).

In the instant VEPCO case it will be noted that the registrant's computations as to the tax effect of the special items resulted in an adjustment of excess profits taxes only; no adustment of normal taxes is indicated See Exhibits A-D.

[31] Under our Rule U-28, moreover, a registered holding company or subsidiary company thereof is forbidden to "distribute to its security holders, or publish, financial statements which are inconsistent with the books of account of such company or financial statements filed with this Commission by, or on behalf of, such company."

[32] Case E-80 reads as follows:

"Question:

Several utilities which have refunded bond issues, have had substantial tax savings in the year the refunding occurred, because the unamortized debt discount, expense and call premium associated with the refunded securities is permitted as an income tax deduction during the year redeemed. Instead of showing the actual taxes paid or accrued in the tax account, the utilities in question have also included therein the amount of the tax saving due to the refunding operation with an offsetting credit usually to Account 140, Unamortized Debt Discount and Expense. Is this permissible?

"Answer: No.

The tax account (507) should include only provision for actual taxes and the account should not be increased by the amount which would have been paid had the refunding transaction not occurred. In other words, there was an actual saving in taxes and this saving should be reflected in the income statement because it is a fact. It is believed, too, that the text of Account 507 does not permit the accounting practice resorted to by the utilities in the illustration cited."

[33] In *State* v. *Public Service Commission*, 336 Mo. 860, 81 S. W. (2d) 628 (1935) the court held that only taxes actually payable need be considered: "The ninth and last point urged in appellant's brief is that 'the Commission's action in refusing to allow the inclusion of Federal income taxes as operating expenses was error.' The undisputed evidence is that the company did not pay income taxes. We are not aware of any authority holding that in such case an allowance of this kind should be made, and counsel for appellant cite none." See also *Re East Ohio Gas Company*, 17 P.U.R. (N.S.) 433, 445 (1937). In *Public Service Commission of Utah* v. *Utah Power & Light Company*, 50 P.U.R. (N.S.) 133, 167 (1943) the company had sought to justify the reasonableness of certain rates by including $1,480,000 of "computed" excess profits taxes in operating expenses. In fact the company neither reported on its tax returns nor paid any excess profits tax. This "computed tax" items thus resembles very closely the so-called "tax savings" in question here. The Utah Commission disallowed the claimed deduction saying: "The injustice to Utah rate payers is obvious when excessive rates and earnings are made to appear to be reasonable by means of computed excess profits taxes which have not been paid or reported to the government. We reject the company's claim that its computed (but not reported or paid) excess profits taxes should be included in the cost of service and thus passed on to the rate payers." . . . .

[34] Where a "sliding scale" formula is in operation, the actual results of current operations, including taxes, are determinative of future rates. In such a case there would, it seems to us, be danger of grave injustice in applying the formula to the results of actual operations for the year which, however, reflected a deduction based on income taxes that were neither paid nor payable by the company.

We come next to the remaining contention urged by the certifying accountants, that as a matter of correct accounting it is necessary to "allocate" income taxes to income and other accounts. This theory is also advocated and developed in detail in a bulletin "Accounting for income taxes" issued in December, 1944, by the Committee on Accounting Procedure of the American Institute of Accountants.

There is no doubt that allocation is a basic accounting procedure. In fact the whole process of preparing income statements is a species of allocation—of determining what revenues are allocable to the current income account and what expenditures are properly to be treated as cost allocable to the current income account. It is not therefore a demonstration of the merit of the proposed device to describe it as an allocation or to say that income taxes should be allocated. Whenever an item is charged to income, or indeed when it is excluded and carried as an asset, "allocation" in the accounting sense has taken place. The issue here is not whether income taxes should be allocated but whether the treatment of income suggested by the accountant's third contention is preferable to the method of allocation heretofore followed—that is, to show as a deduction from income of the current year the income and excess profits taxes which are believed to be actually payable, under the applicable tax law, as taxes of the current year.

In the argument before us and in the bulletin mentioned it has been urged that income taxes are an expense that should be allocated as other expenses are allocated. In neither case, however, was there any effort made to state the reasons why Federal incomes taxes must be considered as an expense in the same category as, let us say, wages. It is obvious, of course, that the net profit applicable to stockholders cannot be determined without first making an appropriate allowance for the amount that must be paid as income taxes. However, this fact does not dispose of the question. It is readily apparent that normal and excess profits taxes are computed as a *part of* taxable net income. Unlike most expenses they exist if, and only, if, there is net taxable income before any deduction for such taxes. There is much to be said therefore for the position that true income taxes are in the nature of a share of profits taken by the government. If it is desired to place emphasis on the necessity of deducting them in order to arrive at net profit available to shareholders, they may perhaps be called an expense—but in such case they represent a very special class of expense, one that is incurred only by the making of a net taxable income.

Accordingly, to the extent that the propriety of the proposed treatment of income taxes depends on their classifications as an expense rather than a share in profits we feel that the case remains unproven. Even if they be so classified, we feel that in view of their unusual and distinctive characteristics the propriety of the proposed treatment is not demonstrated merely by classifying them as an expense and then concluding that for that reason they should be allocated as other expenses are allocated.

We now examine the contention that income taxes should be allocated "as other expenses are allocated." The accountants who appeared before us cited to us no other expense which, for general accounting purposes, is allocated in the manner proposed for income taxes, nor have any such instances otherwise come to our attention. We note, moreover, that in a dissent to the bulletin mentioned earlier it was stated:

> "No expense other than federal income and profits taxes is allocated on the basis of applying to a given transaction so much of the expense as would not have occurred if the transaction to which the expense is attributed had not taken place. The usual method is to allocate a total expense ratably to given accounts or transactions on a consistent basis."

The illustrations of expense allocation cited to us by the certifying accountants in this case appear to us to support the above statement. In each case cited there was an expense actually incurred that was first allocated to the period under the usual accrual principles and then distributed over a number of accounts. In no case was there an estimate made of what the expense would have been under other conditions. In no case cited, was there a distribution of an expense to several accounts by means of what can be termed an algebraic formula in which a negative sum is credited against one item to offset the positive charge to another item of an amount in excess of the actual expense. We do not regard such a treatment as an appropriate means of allocating income taxes in financial statements which purport to reflect the actual results of operations. We have doubt indeed that such a method can properly be termed an allocation at all, as that term is customarily used.

We note, in passing, moreover, that in the examples of expense allocation cited to us there existed a direct, almost physical association between the item being allocated and the item to which it was charged. For example, in the case of real estate taxes allocated to construction the tax item is directly and closely related to the construction. Likewise, in the case of brokerage fees, and stamp or transfer taxes, the tax item is closely and directly related to the specific transaction. *In both cases, moreover, the tax is independent of any other transactions of the*

company. Nor is there any attempt made to increase in the course of the allocation the amount of such taxes to an estimated sum. We feel therefore that such illustrations can not properly be cited in support of the proposed treatment for income taxes.

It is also sometimes pointed out that "cost" in the case of securities or property acquired is generally considered to be the sum of the purchase price plus incidental costs such as brokerage and any specific taxes paid by the buyer and that on sale the proceeds are computed as the selling price less incidental deductions such as commissions or any specific taxes paid by the seller. By analogy and in justification of the proposed treatment of income taxes it is frequently urged that a so-called "tax saving" must be allocated or attributed to or ultimately associated with particular losses or expenses because the tax consequences of the transaction involving the loss or expense were a motivating factor in arriving at the decision to consummate it. Thus, it is claimed that a property would not have been sold but for the "tax saving" thereby effected and that for this reason it is proper to consider that the true "loss" on the sale is not the excess of cost over selling price but is equal instead to the difference between cost on the one hand and selling price *plus* "tax saving" on the other. We do not believe such an analogy is sound and we cannot accept that analysis as a basis for reporting the results of actual operations. It is undoubtedly true that the tax consequences of selling a property often are an important consideration in arriving at the decision to sell, and may in some cases have been a deciding factor. However, tax consequences undoubtedly play an important role in the making of a great variety of decisions involving the incurrence and amounts of purely operating expenses such as advertising, wage rates and bonus plans. Yet it can hardly be argued that wages or bonuses or advertising are to be reported as less in amount because income taxes would have been higher if the amounts spent on such items were less. We see no basis for adopting a different approach in figuring the "loss" involved in a sale of property. We feel instead that there has been a loss of the full difference between cost and selling price coupled with a tax benefit which is properly reflected in the lower taxes actually paid. We feel that the proposed treatment of income taxes tends to obscure these facts and that the treatment of income taxes required by our rules and heretofore almost universally followed clearly discloses what has taken place. Where the tax paid for the year is unusual in amount because of unusual conditions, an appropriate explanation would be called for as is now required in the case of other unusual events.

As to this last principal contention urged by the certifying accountants (that income taxes are an expense that should be allocated as other expenses are allocated) we feel, first, that there is grave doubt whether income taxes can properly be considered as an expense in the same category as the cost of materials or wages, and, second, that the treatment proposed does not result in the allocation of income taxes "as other expenses are allocated." We feel instead that the proposed treatment is purely an effort to have items shown in the income statement at what is considered to be a "normal" amount. We note that this objective is clearly expressed as a prime purpose of the method in the bulletin referred to earlier, which states at p. 185:

> "As a result of such [unusual] transactions the income tax legally payable may not bear a *normal* relationship to the income shown in the income statement and the accounts therefore may not meet a *normal* standard of significance." (Emphasis supplied)

There are, finally, a number of difficulties involved in the proposed treatment of income taxes that deserve mention even though they are not directly relating to the specific contentions put forward by the certifying accountants in the case.

The first involves the preparation of general statistical data from financial reports. Under the method proposed, it is permissible, to show, as taxes, an amount in excess of the taxes payable. If such items are totalled for a period of years or for groups of companies, they may well be used as evidence of the aggregate amount of taxes paid by the company or by the industry. Obviously any such representation is erroneous and will misstate, often very materially, the underlying facts. We feel that we should not permit the filing with us of income statements which readily permit, if they do not actually invite, such misuse. Even a "charge in lieu of taxes" may result in distorted overall statistics since it operates to reduce net income after taxes and so affects the ratio of actual taxes to net income. If the offsetting credit is netted against a surplus charge the distortion may be permanent.[35]

The second and somewhat technical problem is the difficulty of the computation. It

[35] Under one variant of the practice no change is made in *final net income*. In the statements originally filed in the instant case, for example, part of the amount included as a charge among the operating expenses represented a $609,949 reduction in income taxes due to the taking for tax purposes of accelerated amortization of emergency facilities at the rate of 20% a year while in the financial statements only normal depreciation was being accrued. See p. 11 *supra* and Exhibit A. In the original statements this $609,949 was added back as the last item in the account. This internal in-and-out treatment appears to

is usual in contemplating the tax consequences of a proposed transaction to treat it as an incremental or marginal item. Where tax rates are graduated, this results in associating the marginal income or expense with the highest tax bracket. It is questionable, whether such a principle is realistic when applied to the results of operations for a completed year. Net taxable income is a composite of all taxable income and all deductible items applicable to the period. The propriety of singling out any specific item as the item which is taxed in the highest tax bracket, is doubtful. Moreover, in applying the theory to losses and expenses it would appear that the existence of a reduction in taxes is due not only to the expense but is equally dependent on the existence of taxable income to offset the expense. It would appear possible that some part of the benefit from the "reduction" ought to be attributed to the existence of income.[36] Even if this point be waived, however, there has been no satisfactory analysis presented of the effect to be given to the carry-back, carry-forward provisions of the present income tax law. Without exploring all of the possible difficulties, one case may be cited. Suppose that a loss has been charged to surplus but is deductible for taxes. Suppose further that in accordance with the present proposal there is charged to income, as provision for taxes, the amount of $200,000 although the actual tax amounts to only $50,000. If in the next year the company suffers an operating loss of $500,000, then in view of the carry-back provisions the reader of the two income statements would reasonably expect to find a carry-back refund of $200,000—the amount shown as taxes in the first year. However, obviously no more than $50,000 would actually be refundable. The question arises whether having overstated taxes in the first year it is not necessary, to be consistent, to overstate the refund in the second year. Finally, there are the permutations in the computation where a company pays taxes as a member of a consolidated group. In addition to the allocation of the actual tax paid among the several companies in the group, the proposed treatment raises the difficult question of whether the amount of the so-called "saving" is to be computed on the basis of a company's individual status or on that of the consolidated group and, once this is decided, of whether to allocate this "saving" as between the several companies or attribute it solely to the company having the deduction—even though perhaps it itself contributed no taxable income!

The third difficulty is the propriety of singling out the income tax item for adjustment on the ground that it does not bear a "normal" relationship to the income reported. Particularly, under conditions like the present, many if not most of the income and expense items bear unusual relationships to each other. Under the influence of the war sales volumes are often very high. Maintenance may be very high due to continuous operation of the plant, or very low because of the inability to obtain materials and labor, or very high because of the use of inexperienced labor and the inability to get new machinery, or very low because operations cannot be stopped long enough to make thoroughgoing maintenance possible. Selling costs may be very low because of the volume of war business or very high because of the use of advertising to keep restricted products in the public's mind. With many items of income and expense apt to be out of line, there appears to be little justification and a good deal of danger in singling out one item for adjustment.

EXHIBIT A

Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined

Condensed certified statement of income for 1944 as shown in original registration statement and after amendment No. 1[1]

us to suffer from all of the difficulties we have discussed even though no change results in the amount of "net income." In our opinion, an overstatement of operating expenses is not corrected by "adding back" the amount of the overstatement at a later point in the income statement. Such treatment is in our view artificial and deceptive to all but the most experienced reader. While there may be some grounds for crediting such reductions in taxes to a special amortization reserve there is none for the equivocal practice here followed.

[36] We note the customary solution of a somewhat similar problem that arises when a group of companies files a consolidated tax return. In assigning to each constituent its fair share of the consolidated tax paid by the group it is usual to divide the actual tax among the companies who would have had to pay a tax on an individual basis. If one of the included companies operated at a loss, the consolidated tax is of course reduced, but *no* part of the "saving" is ordinarily paid over to the loss company by the other members of the group. Instead, only those *contributing* income to the consolidated return share directly in the benefit of the current reduction. This principle is incorporated in our Rule U-45 under the Public Utilty Holding Company Act.

[1] Note C to the income account as set forth in the registration as originally filed read as follows:

"C. *Federal Income and Excess Profits Taxes*

"Virginia Public Service Company and Subsidiaries—The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring deductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of income for

Item	Amount
Operating revenues	$51,681,778
Operating Expenses and Taxes:	
Other than taxes	28,237,367
Taxes, excluding reductions shown separately below or applied against items charged directly to surplus:	
Federal income (Note C)[1]	2,139,496
Federal excess profits (Note C)[1]	8,164,872
Post-war credit	(351,082)
Other	4,131,408
Total	42,322,060
Net operating revenues	9,359,718
Other income	(45,359)
Gross income	9,314,359
Deductions from income:	
Interest and amortization, etc.	3,719,527
Net income	5,594,832
Reduction in Federal income and excess profits taxes resulting Revenue Code, which facilities ties allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed throughout their normal life and not to replace existing facilities	609,949
Balance transferred to earned surplus	$ 6,204,781

EXHIBIT B

Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined

Condensed certified statement of income for 1944 as shown in amendment No. 2

Item	Amount
Operating Revenues	$51,681,778
Operating Expenses and Taxes:	
Other than Taxes	28,237,367
Taxes:[1]	
Federal income[2]	2,139,496
Federal excess profits[2]	3,406,871
Post-war credit	(351,082)
Other	4,131,408
Total operating expenses and taxes before special charges	37,564,061
Special charges equivalent to reduction in Federal excess profits taxes resulting from special amortization of emergency facilities (reduction shown separately below) and from redemption of bonds and sale of property (reductions applied against related items charged to surplus)	4,757,999
Total operating expenses and taxes including special charges	42,322,060
Net operating revenues	9,359,718
Other income	(45,359)
Gross income	9,314,359

1942 as special amortization of debt discount and expense. The balance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942 was charged against earned surplus.

"However, the taxable net income as computed did not reflect the deduction, for tax purposes, of losses upon sales of ice and railway property, and certain other items charged to surplus. As a result, provisions charged to income in 1942 were approximately $330,000 in excess of the company's liability for Federal income taxes as shown in its tax return for that year. Pending review of the returns, this excess provision is included in accrued Federal income and excess profits taxes at December 31, 1943.

"In 1943 the company filed a claim for refund of 1941 Federal taxes in the net amount of approximately $297,000 under the carry-back provisions of the 1942 Revenue Act. However, this amount is subject to such adjustments as may result from review by the U. S. Treasury Department and the claim has not been recorded upon the books of the company.

"Federal income and excess profits tax returns for the company and its subsidiaries for years prior to 1942 have been examined by the Treasury Department and those for the years prior to 1941 have been closed, except for the year 1937 in respect of which a claim for refund is pending."

First Amendment:

The following paragraph was added to Note C:

"*Virginia Electric and Power Company*—In addition to the reduction in Federal taxes on income shown in the income statement for 1944, reductions in excess profits taxes aggregating $4,148,050 have been applied against items charged directly to earned surplus."

The first paragraph of Note C as above quoted was also modified to reflect an amendment to the form of the profit and loss statement for Virginia Public Service Company. As amended the paragraph reads as follows:

"*Virginia Public Service Company and subsidiaries*—The statements of income for the year 1942 include provison for Federal normal income and excess protfis taxes computed without the benefit of the deduction of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these

Deductions from income:	
Interest and amortization, etc...	3,719,527
Net income	5,594,832
Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed throughout their normal life and not to replace existing facilities	609,949
Balance transferred to earned surplus	$ 6,204,781

EXHIBIT C

Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined

Condensed certified statement of income for 1944 as shown in amendment No. 3

Item	Amount
Operating revenues	$51,681,778
Operating Expenses and Taxes:	
Other than taxes	28,237,367
Taxes:	
Federal income (Note C)[1] ..	2,139,496
Federal excess profits (Note C)[1]	3,406,872
Post-war credit	(351,082)
Other	4,131,408
Total operating expenses and taxes (before special charges below)	37,564,061
Net operating revenues (before special charges below)	14,117,717
Other income	(45,359)
Gross income (before special charges below)	14,072,358
Special charges equivalent to reduction in Federal excess profits taxes resulting from redemption of bonds ($2,091,117) and sale of property ($2,056,873) (reductions applied against related items charged to surplus).....	4,148,050
Gross income (after special charges)	9,924,308
Deductions from income:	
Interest and amortization, etc...	3,719,527
Net income	$ 6,204,781

EXHIBIT D

Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined

Condensed certified statement of income for 1944 as shown in amendment No. 4

Item	Amount
Operating revenues	$51,681,778
Operating Expenses and Taxes:	
Other than taxes	28,237,367
Taxes:	
Federal income (Note C)[1]..	2,139,496
Federal excess profits (Note C)[1]	3,406,872
Post-war credit	(351,082)
Other	4,131,408

non-recurring deductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of earned surplus for 1942 from the balance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942."

[1] The language "excluding reductions shown separately below or applied against items charged directly to surplus" included in original registration and Amendment No. 1 was deleted from this caption by Amendment No. 2.

[2] *Federal income and excess profits taxes.*
Note C to the income account as shown in the registration as originally filed after Amendment No. 1 was changed by Amendment No. 2 as follows:
The paragraph added by the first amendment was deleted. Also the first paragraph of the original Note C was deleted.

[1] *Federal income and excess profits taxes.*
Note C to the income account as shown in the registration as originally filed and after Amendments 1 and 2 was changed by Amendment No. 3 by adding the following two paragraphs:
"*Virginia Electric and Power Company*—In addition to the reductions of Federal excess profits taxes payable for the year 1944 which resulted from costs and losses charged to surplus and for which special charges of equivalent amounts have been made in the income statement for that year, such taxes were further reduced $537,496 by reason of the deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the Company's accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.
"*Virginia Public Service Company and Subsidiaries*—Federal excess profits taxes payable for the period from January 1 through May 25, 1944 were reduced $72,453 by reason of a deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision

Total operating expenses and taxes	37,564,061
Net operating revenues	14,117,717
Other income	(45,359)
Gross income	14,072,358
Deductions from income:	
Interest and amortization, etc.	3,719,527
Special charges of those portions of premium and expenses on redemption of bonds ($2,091,177) and of loss on sale of property ($2,056,873) which are equivalent to resulting reduction in Federal excess profits taxes	4,149,050
Net income	$ 6,204,781

has been made in the companies' accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities."

[1] *Federal income and excess profits taxes.*

Note C to the income account as finally amended comprised 6 paragraphs. Three were identical with paragraphs 2, 3, and 4 of the original note. The other three read as follows:

"*Virginia Electric and Power Company*—Federal excess profits taxes payable for the year 1944 were reduced $4,685,546 by reason of deductions for tax purposes of redemption premiums and expenses incurred in refunding of bonds, of a loss sustained on the sale of transportation property and of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. There have been included in the income statement for 1944 as special charges those portions of the refunding costs ($2,091,177) and of the loss on sale of property ($2,056,873) which are equivalent to the reductions in taxes resulting from these particular transactions, the remainder of such costs and loss being charged against earned surplus. No provision has been made in the company's accounts or income statement for the additional amortization allowable in respect of emergency facilities, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.

"*Virginia Public Service Company and subsidiaries*—The statements of income for the year 1942 include provison for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting unamortized debt discount, call premium and expense on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring reductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of income for 1942 as a special charge of debt discount, call premium and expense. The balance of unamortized debt discount, call premium and expense on long-term debt called for redemption in 1942 was charged against earned surplus.

"Federal excess profits taxes payable for the period from January 1 through May 25, 1944 were reduced $72,453 by reason of a deducton for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the companies' accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities."

SUPPLEMENT TO THE SEPTEMBER 1945 ISSUE

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Certified Public Accountant

The Scorecard on Reconversion

By J. A. LIVINGSTON

What Major Problems Are, What Agencies Are Doing, How Long They'll Last

Problem	Responsible Agencies	Immediate Policies or Plans	General
Cutbacks	Army, Navy, Maritime Commission.	Cutback to minimum requirements immediately. No "make-work" orders to sustain production.	Must still determine size of post-war army-navy; develop a long-term procurement schedules; demobilize troops; maintain and supply occupation forces.
Contract Settlement	Office of Contract Settlement: Army, Navy, Maritime Commission, Treasury, a few others.	To close out contracts promptly, help contractors obtain reconversion loans if settlements are held up.	OCS strictly a war agency; some contracts will linger on, but with contracting agencies or in courts.
Plant Clearance	Office of Contract Settlement, Surplus Property Board, Reconstruction Finance Corp., Army, Navy.	Expand personnel—need consultants on inventory valuations. Acquire additional warehouse space if necessary.	Biggest complaints against government likely to come from companies with clogged plants.
Surplus Disposal	Surplus Property Board (overall policy), Commerce (consumer goods), RFC (aircraft, plants, machinery), Maritime Commission (ships and maritime property), Agriculture (agricultural commodities), NHA (housing) Army-Navy Liquidation Commissioner (foreign).	Surplus Property Board must develop broad policies on disposal: must steer a middle-of-the-road course between unsettling markets and having large carry-overs. Army and navy must declare surpluses promptly. RFC, Commerce, must build up sales organization; determine channels of distribution. Must advertise. Surplus disposal is far behind other reconversion activities, largely because law was passed late. But bulk of goods for sale won't be offered for several months.	Plants offer special problem. Agency must guard against monopoly. Many plants good only for munitions output may be held as "standby." Surplus Property Board likely to have work to do for several years. President Truman has recommended a one-man administrator instead of the three-man Surplus Property Board. Maritime Commission must work out plan for selling or chartering, excess merchant ships and operating U. S. Merchant Marine.
Production Controls	War Production Board.	Has already relaxed most L and M orders; will try to guard against inventory hoarding, and to break bottle-necks. Controls to be continued on crude rubber, tin, some kinds of lumber, and a handful of other items. CMP out Sept. 30.	WPB not yet through as a control agency; at dissolution, residual functions will go to the Commerce or other permanent agency.
Manpower	War Manpower Commission.	Has ended controls; workers no longer need certificate of availability; employers can hire when, whom, and where they please. 48-hour week out. Will operate United States Employment Service to direct workers and veterans to jobs.	WMC through as control agency; functions of worker guidance through USES may pass over to Department of Labor or Federal Security Agency. Congress must decide whether to continue USES under federal operation, rather than return to 48 separate state operations.
Transportation	ODT (PAW and OPA).	Railroad regulations to be ended as soon as traffic falls off—demurrage, maximum loading rules, convention ban. End of gasoline rationing should increase motor travel, relieve some of passenger train burden.	ODT still maintaining a few controls, but dissolution as war agency is likely soon.
Price Controls	Office of Economic Stabilization; Office of Price Administration.	To maintain ceilings on prices and rents where demand outstrips immediate supply; to establish prices on reconversion goods promptly. Some ceilings in luxury items have been dropped; rent controls will end when housing supply in any area seems reasonably sufficient.	To check an inflation price spiral without causing delays in reconversion. Must develop machinery to handle appeals quickly. OES and OPA are key reconversion agencies, since prices control profits and wages.
Wage Controls	Office of Economic Stabilization, War Labor Board; later Department of Labor.	To hold wages in check so that prices are not forced up; to avert strikes. Will permit wage increases which do not result in price increases, also to attract labor to low-pay industries and to adjust sub-standard wage rates. To boost Fair Labor Standards minimum wage from 40c an hour to at least 50c.	To restore collective bargaining, so that management and labor can settle own disputes or use regular government mediation services. WLB soon will pass out of control picture; mediation function going to some other agency, possibly labor.
Rationing	OPA, Agriculture (PAW, WPB).	To eliminate rationing as soon as supplies seem large enough to permit relatively equitable distribution; blue-point canned goods rationing dropped, also gasoline.	Rationing function of agencies passing out quickly. Some food rationing — sugar, fats, oils — likely to last for some time.

Veterans	Retraining and Reemployment Administration. Veterans Administration, Selective Service, USES, Congress.	To assist veterans in finding jobs, promote vocational guidance, send to school either for formal education or job training; assist in readjustment to civilian life, administer G.I. loans for houses, business, farms.	Permanent hospitalization will be required for severely wounded and psychiatric cases. Congress must clarify reemploymtnt rights of veterans. Life of Selective Service depends on Congressional action on peace-time conscription.
Foreign Trade	FEA, State (WPB, Agriculture), Congress.	To supply foreign countries with goods essential to their economies and to collaborate with other countries in proportioning world supplies of scarce goods—leather, tin, crude rubber, for example. A few controls will be necessary to prevent American importers from buying more than this country's agreed-on share and foreign buyers from pre-empting short domestic supplies. Most controls on exports and imports will be dropped simultaneously with domestic controls.	To assist expansion of foreign trade, develop good will. Congressional approval of Bretton Woods agreement. Trade Agreements Act, Export-Import Bank extension and United Nations Charter, big steps forward. Must repeal Johnson Act forbidding foreign loans.
Agriculture	Department of Agriculture.	To estimate food needs of U. S., Allies, and liberated areas for 1946; to develop a crop program to meet U. S. and foreign requirements.	Agriculture, however, must adjust to world supply-demand position. Farmers are now helped by support prices which will continue for at least two years; eventually, however, shifts out of surplus crops, like cotton, will be necessary if agriculture is to be self-supporting.
Social Security	Congress; Federal Security Agency.	Unemployment compensation — raise maximum payment to $25 per week and duration to 26 weeks; also widen coverage; system does not cover federal workers, agricultural workers, domestic servants, self-employed and others. Raise veterans unemployment allowances to $25 per week. Broaden Social Security Act to cover medical attention.	Re-examination required of whole Social Security program, including old-age pensions, coverage, and methods of financing.
Taxation	Treasury, Congress.	Drop excess profits tax promptly; reduce income tax in lower brackets.	Revise tax structure so as to stimulate private investment.
Construction	OWMR, WPB, OPA, WLB, NHA, other agencies.	To get industry started quickly, but avoid scramble which would tie up contractors, boost prices. Need is to get manufacturers of plumbing & heating equipment, hardware, building materials producing so as to fill shelves of building supply dealers throughout the country. Also lumber production must be boosted. Plans must be drawn, projects laid out. OPA-WLB price-wage-rent controls have bearing on ability of industry to get started.	Industry is regarded as "white hope" of recovery. Contractor organizations have been scattered—carpenters have gone to shipyards, plumbers to metal-working plants, etc.—and must be rebuilt. Public works projects must be synchronized with private operations (see below).
Public Works	Numerous agencies: OWMR, Federal Works, National Housing, Treasury, Post Office, Interior, etc.	To develop a co-ordinated shelf of public works, to take up slack in construction industry whenever gaps appear.	In early months of reconversion, private demand for workers and materials will probably exhaust supply. Thus public works must be timed so as to start when they will do most good in providing employment. Necessary as longer term gap-filler.
Fiscal Policy-and Full Employment	Congress, Treasury, Budget Bureau, Federal Reserve Board, Office of Economic Stabilization.	Reducing taxes, federal and corporate, enough to check deflation but not enough to cause inflation.	Long-term policy of Administration is to get passage of full-employment bill which would establish machinery in Congress to coordinate all factors in government affecting fiscal policy, including taxation, expenditures, public works, Treasury bond sales.
Reconversion (as a whole)	OWMR: Has organized Reconversion Working Committee (which consists of 25 war agencies and departments).	To facilitate quick reconversion. Will examine plans of war agencies to see that they are in harmony—particularly to see that dropping of controls by one agency doesn't pull out props from another.	Longer-run objective is to obtain a high-production, high-employment economy without inflation. OWMR is most likely to survive as oldest war agency; may become President's economic planning agency in combination with Budget Bureau.

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